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Issues Relating to Pre-IPO Equity Participation in PRC Companies by Overseas PE Funds

By Wayne Chen and Patrick Chen

The rapidly-developing Chinese economy attracts overseas PE funds to invest in China. Generally speaking, when overseas PE funds make investment into PRC companies, they are not only concerned about the investment but also pay close attention to the future exit modes. At present, to push an invested company to be converted into a company limited by shares and listed in China's A-share market has become an exit mode accepted by overseas PE funds. Set out below is our brief introduction to some of the issues to which we would like to draw your attention when making pre-IPO equity investment in PRC companies by overseas PE funds:

Arrangement of Fixed Returns

In accordance with current PRC Company Law (**Company Law**), if the PRC company invested by an overseas PE fund invests is an equity joint company with limited liability (**EJV**), the shareholders of the EJV can distribute the dividends in accordance with the agreed proportions.

In accordance with the Implementing Rules of the PRC Sino-foreign Co-operative Joint Venture Law, if the PRC company invested by an overseas PE fund is a cooperative joint venture company (**CJV**), it is allowed to increase the portion of foreign investors in proceeds distribution pursuant to the cooperative joint venture contract.

As such, it is viable under current PRC law if it is agreed that overseas PE funds are entitled to more dividends than those in terms of their equity proportions under the foregoing two scenarios. However, we would like to draw your special attention to the following: if it is agreed that overseas PE funds are entitled to fixed returns provided by the invested company, then that would be possibly unacceptable under current PRC law. The essential difference between the two arrangements is that, the arrangement under which overseas PE funds are entitled to more dividends than those in terms of their investment

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proportions is still made on the basis of the basic principle that the shareholders of the company take joint risk on profit or loss of the company, and if the invested company is run at loss, none of its shareholders will receive any dividends. However, under the fixed returns mode, the investors will receive their relevant returns regardless whether or not the invested company is profitable. That is in violation of the basic principle that the shareholders should take joint risks on profit or loss of an invested company and will possibly neither be accepted by the relevant authority of foreign investment nor be upheld by a PRC court in case of dispute.

If the invested PRC company is a company limited by shares, according to the principle of same share having same rights under the Company Law, the arrangements of being entitled to more dividends than those in terms of their investment proportions and fix returns are not allowed.

Lock-up Period

In accordance with Article 8 of the Tentative Provisions on Certain Issues on the Establishment of Foreign-invested Companies Limited by Shares (**Tentative Provisions**), a promoter's shares can not be transferred until the three-year period has expired from the date of incorporation of the company. Since the Company Law amended in the year of 2005 has shortened the time limit on a promoter's transfer of its shares of a company limited by shares from three years to one year after the incorporation of the company, even though the Tentative Provisions has not been amended accordingly, in practice the lock-up period provided under the Company Law is applicable to the share transfer of a promoter in a foreign-invested company limited by shares.

If the shares of a foreign-invested company limited by shares are listed in China's A-share market, in accordance with Article 142 of the Company Law, the shares issued by the company before its public offering can not be transferred within one year from the date when the shares are traded at a stock exchange. The investors can transfer their shares to any third party after the foregoing one-year lock-up period.

One noteworthy point is that, in addition to the lock-up period provided under the Tentative Provision and the Company Law, according to Article 5.1.4 of the Regulations on Listing at Shanghai Stock Exchange and Articles 5.1.5 and 5.1.6 of the Regulations on listing at Shenzhen Stock Exchange, if an investor is the controlling shareholder or de facto controller of an issuer, the investor shall not transfer its shares of the issuer within three years from the date when the shares of the listed company are traded; and if the issuer increases its capital within one year prior to the publication of its prospectus, the shareholders of the new shares shall not transfer the new shares they hold within three years from the date of the registration of the capital increase with the relevant AIC office.

Withholding Tax

In accordance with the PRC Corporate Income Tax Law and the Implementing Regulations of the PRC Corporate Income Tax Law, in the case that a PRC company pays dividends to an overseas PE fund as its shareholder, an income tax at a rate of 10% shall be withheld by the PRC company for its foreign shareholder, and in case of other incomes obtained by the overseas PE fund, the withholding tax rate is 20%.

In accordance with the Arrangement between the Mainland of China and Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income, if a Hong Kong PE fund directly owns at least 25% of shares or equity in a PRC company, the dividends will bear a withholding tax at a rate of 5%, and 10% under other scenarios.

In accordance with the Arrangement between the Mainland of China and Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income, if a Hong Kong PE fund directly owns at least 25% of shares or equity in a PRC company, the dividends will bear a withholding tax at a rate of 5%, and 10% under other scenarios.

Restrictions on Foreign Exchange

In accordance with Article 4 of the Circular on Some Issues Concerning Capital Changes of Enterprises with Foreign Investment and the Directions of State Administration of Foreign Exchange on Foreign Exchange, when an overseas PE fund as the shareholder of a PRC company transfers its shares or equity in the company, the transferee can purchase foreign currency to pay to the overseas PE fund. It is our understanding that the foregoing provisions shall apply to the share transfer of an unlisted company. Except for the foregoing general provisions, currently, there are no specific rules on the exit by overseas PE funds from A-share market in respect of foreign exchange administration.

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