LLINKS Law Offices
通力律师事务所

Shanghai
19F, ONE LUJIAZUI
68 Yin Cheng Road Middle
Shanghai 200120 P.R.China
Tel: (86 21) 3135 8666
Fax:(86 21) 3135 8600

Beijing
Units 902-903
Winland International Finance Centre
No.7 Finance Street, Xicheng District
Beijing 100033 P.R.China
Tel: (86 10) 6655 5050
Fax:(86 10) 6655 5060

上海
上海市银城中路68号
时代金融中心19楼
邮政编码: 200120
电话: (86 21) 3135 8666
传真: (86 21) 3135 8600

北京
北京市西城区金融大街7号
英蓝国际金融中心9楼02-03单元
邮政编码: 100033
电话: (86 10) 6655 5050
传真: (86 10) 6655 5060

www.llinkslaw.com
master@llinkslaw.com

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Legalization of Equity Contributions by Foreign-invested Enterprises

By David Yu, Nicholas Lou and Teddy Li

It is provided in the Company Law of the People's Republic of China (2005 Revision), that shareholders of a company may make capital contributions in the form of both currency and non-currency properties (such as items, intellectual property rights and land-use rights) that can be monetarily evaluated and legally transferred. In 2009, the State Administration for Industry and Commerce promulgated the *Measures for Administration of the Registration of Equity Contributions* for implementation, serving as the operational guidelines for equity contributions. However, it was until May 2011 that we witnessed the issuance of the *Measures for Administration of Equity Contributions of Foreign-Invested Enterprises (Draft for Discussion)* by the Ministry of Commerce ("**MOFCOM**"), containing rules regarding the equity capital contribution ("**Equity Contribution**") made by foreign-invested enterprise ("**FIEs**"). On 21 September 2012, MOFCOM officially issued the *Interim Regulations of the Ministry of Commerce on Equity Contributions of Foreign-Invested Enterprises* ("**Interim Regulations**"), taking up the vacancy where detailed administration rules regarding the FIE's Equity Contribution has been missing in the book of approval authorities for foreign investments. This article briefly introduces and comments on the Interim Regulations.

Primary Contents of Interim Regulations

- Scope of Application and Transaction Types Likely Involved

  - Scope of Application of Equity Contributions

    Interim Regulations shall apply where a domestic or overseas investor ("**Equity Contributor**") makes capital contributions with his/her/its equity in an enterprise ("**Equity Enterprise**") within China to establish or alter a FIE. Equity contributions concerning enterprises from Taiwan, Hong Kong and Macao shall also follow the Interim Regulations. In accordance with the Interim Regulations, means of Equity Contributions include establishing new foreign-invested companies, change non-FIEs into FIEs by increasing capital, and alter the shareholding of FIEs by increasing capital.

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郭建良: (86 21) 3135 8756
Publication@llinkslaw.com

If you would like other Llinks publications, please contact:

Roy Guo: (86 21) 3135 8756
Publication@llinkslaw.com

Llinks Law Offices
www.llinkslaw.com

- Main Transaction Types Likely Involved

  The following is a chart illustrating primary transaction types involved in Equity Contributions demonstrated in accordance with the natures of parties concerned:

Equity Contributor ("A")	**Equity Enterprise[1] ("B")**	**Invested Enterprise ("C")**	**Method of Equity Contributions and Transaction Types Involved**	**Consequence of Transaction**
Overseas Investor	FIE	Newly Established FIE	**Means of Equity Contributions:** The overseas investor makes Equity Contributions to establish a new foreign-invested enterprise with his/her/its equity in a foreign-invested enterprise. **Transaction Type:** Foreign-direct-invested enterprise B turns into an FIE re-invested enterprise (provided that B has no other direct overseas investors).	A becomes the shareholder of C, C becomes the shareholder of B
		Existing FIE	**Means of Equity Contributions:** The overseas investor makes Equity Contributions to increase the capital of an existing FIE with his/her/its equity in another FIE. **Transaction Type:** The shareholding of FIE C alters, and foreign-direct-invested enterprise B turns into an FIE re-invested enterprise (provided that B has no other direct overseas investors).	
		Chinese Domestic Enterprise[2]	**Means of Equity Contributions:** The overseas investor makes Equity Contributions to increase the capital of another Chinese domestic enterprise with his/her/its equity in an FIE. **Transaction Type:** A, as a foreign investor, acquires C, and B turns into an FIE re-invested enterprise (Provided that B has no other direct overseas investors).	
Domestic Investor	FIE	Newly Established FIE	**Means of Equity Contributions:** The domestic investor makes Equity Contributions to establish a new FIE with his/her/its equity in an existing FIE. **Transaction Type:** The shareholding of B alters.	
		Existing FIE	**Means of Equity Contributions:** The domestic investor makes Equity Contributions to subscribe the capital increase of an existing FIE with his/her/its equity in another FIE. **Transaction Type:** The shareholding of both B and C alter.	
		Chinese Domestic Enterprise (include newly established and through capital increase)[3]	**Means of Equity Contributions:** The domestic investor makes Equity Contributions to establish a new Chinese domestic enterprise or increase the capital in a domestic enterprise with his/her/its equity in an FIE. **Transaction Type:** The shareholding of B alters.	

- Equity Swaps Shall Also Apply

Besides governing Equity Contributions, article 25 of the Interim Regulations further provides that, if foreign investors engages in any equity swap using equity in FIEs as consideration to obtain the equity in other enterprises in China held by other investors, such equity swap shall comply with relevant provisions regarding the prerequisites of Equity Contributions and equity evaluation, etc. set forth in the Interim Regulations, as well as those in the *Provisions on the Alteration of Equity Held by Investors in Foreign-invested Enterprises*, and *Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*. Nevertheless, detailed application rules of equity swaps are yet to be clarified and tested through future practice.

➢ Regulating Equity Contributions

Interim Regulations has set forth specific regulations on the conditions, limitations, evaluation and pricing, and approval authority of Equity Contributions, and also the application of policies concerning the admission of foreign investments and their approval procedures, etc. Such rules include:

- Conditions and Limitations Applicable to the Equity Enterprise and the Equity to Be Contributed

In accordance with article 4 of Interim Regulations, Equity Enterprise and the equity used in Equity Contribution shall comply with the following conditions/limitations:

i. The equity contributed shall be legally transferable and shall not be pledged or frozen;

ii. The equity of real estate enterprises, foreign-funded investment companies and foreign-invested venture (Equity) investment enterprises shall not be used as capital contributions;

iii. The establishment of Equity Enterprises shall be duly approved and the policies governing industries for foreign investment (applicable where the Equity Enterprise is an FIE) shall be duly complied with;

iv. The registered capital of the Equity Enterprise shall be fully paid up and such equity transactions shall not be prohibited by the articles of association of the Equity Enterprise;

v. Equity Enterprise takes part in annual inspection and has passed the preceding joint annual inspection (applicable where the Equity Enterprise is an FIE).

- Threshold of Foreign Investors

Equity Contribution may lead to a conversion of nature of and Equity Enterprise and the target company, including situations where an FIE changes into an FIE re-invested enterprise, and where a Chinese domestic enterprise changes into an FIE. In this regard, article 5 of Interim Regulations provides that after Equity Contribution, the target (invested) enterprise and the Equity Enterprise, along with their direct or indirect holding companies, shall fully comply with the *Provisions on Guiding the Orientation of Foreign Investment*, *Catalogue of Industries for Guiding Foreign Investment* and other foreign investment regulations. Any company within the above scope does not or will not comply with the above regulations, shall spin off relevant assets and businesses that cause the non-compliance or undergo equity transfer before its application of Equity Contribution. Under no circumstances shall a foreign investor evade administration by using any means of Equity Contribution.

As such, enterprises directly or indirectly held by FIEs shall also comply with relevant Chinese rules and regulations concerning the industries of admission and limitation on foreign investors. Consequently, Chinese domestic enterprises whose business scopes contain restricted or prohibited industries to foreign investors will need to pay particular attention to the problems of industry admission likely involved in the Equity Contribution and are recommended to take corresponding measures to avoid non-compliance.

It is also noteworthy that with regard to the abovementioned relevant conditions and limitations, Interim Regulations further requires legal opinions to be issued by law firms on whether Equity Enterprise and its equity used in Equity Contribution comply with the Interim Regulations, which shall serve as one of the application documents submitted by the FIE to apply for Equity Contribution. Such demand however, is rarely seen in China's practice concerning approval and admission in relevant foreign investment regime.

➢ Power of Approval Authority

With regard to the power of approval authority, the Interim Regulations provides that, all Equity Contributions shall be subject to the approval of MOFCOM at provincial level (i.e. the MOFCOM in the provinces, autonomous regions, municipalities and cities specially designated) where the target (invested) enterprise is located, except for those specifically required to be approved by MOFCOM in accordance with the relevant regulations concerning approval and admission of foreign investments.

- Approval Procedure

Articles 11 to 17 of the Interim Regulations set forth the approval procedure of Equity Contribution, as well as carry-over processes with other competent governmental departments. The main approval procedure of Equity Contribution is as follows:

The investor or the target (invested) enterprise file an application with the approval authority for the approval of Equity Contribution.

Where the Equity Enterprise is a FIE and is approved by an authority different from that of the target (invested) enterprise, the approval authority of the target (invested) Enterprise shall seek the opinions of the approval authority of the Equity Enterprise.

Upon approval, the approval authority shall issue (or exchange) an approval certificate specifying "equity contribution not fully paid".

If the Equity Enterprise is not an FIE, the Equity Enterprise shall complete the formalities for filing or approval according to rules governing FIE re-invested enterprises and other relevant provisions. If its business scope covers any restricted fields of foreign investment, the Equity Enterprise shall further obtain approval by authorities at the provincial level concerning FIE's re-investments.

If the Equity Enterprise is an FIE, and provided that after Equity Contributions, there will still be foreign investor(s) left as shareholder(s), the Equity Enterprise shall undergo applications in accordance with the relevant provisions on the alteration of FIEs.

If the Equity Enterprise is a FIE, and provided that after the Equity Contribution, there will be no foreign investors left as a shareholder, the Equity Enterprise shall undergo relevant formalities for filing and approval according to the relevant provisions of the alteration of FIEs and re-investments by FIEs.

After Equity Enterprise's completion of the above procedure, the holder of equity used for capital contribution will turn into the target (invested) enterprise.

In accordance with relevant provisions, Equity Enterprise shall undergo formalities for registration modification at competent departments of industry and commerce, tax, foreign exchange, etc.

The target (invested) enterprise files an application with the approval authority for changing approval certificate specifying "equity contribution fully paid".

Additionally, the Interim Regulations also set forth regulations on equity evaluation and pricing mechanism, Equity Contribution concerning Chinese domestic listed companies or state-owned properties, and the administration of foreign debt, import tax-free quota and the coordination among other competent governmental departments related to Equity Contribution.

Comment

As a means for restructuring, making investment through equity contributions is attracting great attentions of global investors, widely known for its advantages in investment consideration, tax, transaction cost and other aspects. These advantages makes equity investment widely applicable in commercial transactions concerning cross-border merges and acquisitions, optimization of tax structure, equity or business restructuring of enterprises, etc.

The release of Interim Reputations has provided legal basis and operation guidelines for Equity Contribution, filling in the statutory blanks. Nevertheless, there may still exist certain practical issues in Equity Contribution, such as the complexity of its approval procedures, lagging approval period, and possible problems in the approval procedures involving other governmental departments and relevant organizations (including but not limited to competent departments governing state-owned assets, CSRC, securities depository and clearing corporations). As such, further understanding and joint efforts are expected of all parties involved in practice.

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1 In accordance with Interim Regulations, “enterprise” refers to limited liability companies or joint stock limited companies.

2 The article 22 of Interim Regulations sets forth regulations governing Equity Contributions by foreign investors to merge with Chinese domestic enterprises.

3 Article 24 of the Interim Regulations has set forth regulations on the situation where domestic investors make capital contributions to domestic-funded-enterprises with the equity in FIEs.

Contact Details

If you would like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual Llinks contact.

Shanghai	Beijing
David Yu Tel: (86 21) 3135 8686 David.Yu@llinkslaw.com	**David Yu** Tel: (86 10) 6655 5050 David.Yu@llinkslaw.com
Ming Zhang Tel: (86 21) 3135 8777 Ming.Zhang@llinkslaw.com	**James Weng** Tel: (86 10) 6655 5050 - 1028 James.Weng@llinkslaw.com
Bernie Liu Tel: (86 21) 3135 8678 Bernie.Liu@llinkslaw.com	