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 100140 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: 100140
电话: (86 10) 6655 5050
传真: (86 10) 6655 5060

www.llinkslaw.com
master@llinkslaw.com

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# M&A Loans and Financing for M&A Deals

**By David Yu, Sam Feng and Cathy Huang**

The China Banking Regulatory Commission (**CBRC**) released *the Guidelines on the Risk Management of M&A Loans of Commercial Banks* (**Guidelines**) on 6 December 2008, which aim to provide the legal basis and practical guidelines to allow commercial banks to launch an M&A loan business and to support the financing of M&A deals in China.

## Key Provisions of the Guidelines

The Guidelines allow commercial banks to provide loans for M&A deals but set restrictions on M&A loans based on the principles of compliance, prudential operation, effective risk control and sustainable development of the banking industry.

- "M&A loans" are defined under the Guidelines as "loans provided by commercial banks to the merging or acquiring party or its subsidiary for the payment of the proposed merger or acquisition".

- According to the Guidelines, "M&A" refers to a transaction where a company merges with or acquires to actually control an existing company by means of equity transfer, subscription to new capital, acquisition of assets or debts. Thus, "M&A" includes acquisitions of equity rights and assets.

- Commercial banks providing M&A loans must meet the following criteria:

  - Effective risk management and efficient internal control mechanism;

  - Adequacy ratio of loan loss provision of no less than 100%;

  - Capital adequacy ratio of no less than 10%;

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韩东红: (86 21) 3135 8709
Publication@llinkslaw.com

If you would like other Llinks publications, please contact:

**Lily Han:** (86 21) 3135 8709
Publication@llinkslaw.com

**Llinks Law Offices**
www.llinkslaw.com

- General provision balance of no less than 1% of the loan balance; and

- Due diligence and risk assessment professionals for M&A loans.

➢ According to Article 8 of the Guidelines, commercial banks are required to fully assess risks in M&A loans, including strategic development, legal compliance, overall risk, operation, finance and any other risks related to M&A deals. Chapter 2 of the Guidelines further enumerates the various risks as mentioned in Article 8.

➢ Article 18 of the Guidelines aims to restrict highly-leveraged M&A deals by providing that “the leverage ratio of M&A loans in funding resources shall not exceed 50%”.

➢ The basic requirements for making M&A loan applications set forth under Article 22 of the Guidelines mainly focus on the legal compliance of the purchaser and M&A deals, and industrial or strategic correlations between the purchaser and the target company.

➢ Articles 27 and 28 of the Guidelines stipulate the key clauses that should be included in M&A loan agreements in order to protect the interests of commercial banks as well as the applicability of such clauses. The details are as follows:

- Terms on the important financial conditions of the borrower or the entity formed after M&A deals;

- Mandatory terms on premature repayment of the loan by use of the borrower’s additional funds for repayment in advance;

- Terms of monitoring on the principal accounts or special accounts of the borrower or of the entity formed after M&A deals; and

- Commitments from the borrower for ensuring the lender’s right to know or approve any material issues.

The above clauses are designed to mitigate the risks of commercial banks in the events of (1) changes of major shareholders; (2) changes of large-sized investment projects; (3) abnormal changes of operation costs; (4) material adverse changes in brand names, customers and marketing channels; (5) new material debts or external guarantee; (6) sales of the important assets; (7) material changes of bonus distribution strategies.

## Impacts of the Guidelines on M&A Financing in China

Before the promulgation of the Guidelines, unless otherwise permitted by other national provisions, loans were not allowed to be invested in equity rights in accordance with Article 20 of the General Provisions on Loans (**Provisions**) issued by the People’s Bank of China on 1 August 1996. In practice, domestic financial institutions could provide financial support for M&A deals only by obtaining special approval from the government and on a case by case basis, by settlement of trust or through strategic banks. As the Provisions provide further prohibitive rules against M&A loans, only medium- and large-sized state-owned enterprises are capable of being financed by M&A loans. Many more other enterprises which have lost opportunist of completing M&A deals owing to lacking of support by M&A loans or have financed their M&A deals in breach of the relevant rules. This has been a major obstacle in the development of China's M&A market.

Since 2008, the government has started to remove the restrictions on M&A loans following the increasing demand for M&A financing in China as well as the establishment and improvement of the banking industry's risk control system. Promulgated on 13 December 2008, *Several Opinions of the General Office of the State Council on Providing Financing Support for Economic Development* allows commercial banks offering M&A loans to both local and foreign enterprises as an important measure to resist the global financial crisis, boost domestic demand and assist in China's economic growth. Moreover, *the Notice of Adjusting Partial Credit Monitoring Policies to Promote the Steady Development of the Economy* as issued by CBRC on 10 January 2009 has given top priority to "supporting eligible commercial banks to launch M&A loan business" among the ten credit and financing regulatory policies.

The Provisions, which were issued in 1996, are departmental rules. The Guidelines are departmental guidelines. Although the Guidelines have a slightly lower effect than the Provisions, the restrictions on "M&A loans", which were imposed in China more than 12 years ago, have actually been removed by a series of national policies. The removal of such restrictions resolves enterprises' major financing problems in M&A activities, including M&A of listed companies, overseas acquisitions as well as acquisitions as a going concern.

M&A loans have been widely used in M&A deals in western developed countries with a long history. In general, the purchasing company only needs to provide a small portion of its own funds to merge or acquire the target company with M&A loans, which gives remarkable leverage in financing such M&A activities. Therefore, M&A activities financed by M&A loans are also known as leveraged M&A. The main reason for the common use of M&A loans in western developed countries is that huge investment benefit may be generated with just limited amount of investment in M&A activities financed by M&A loans, given that such western countries have established effective banking and financial systems, mature credit and finance mechanisms and a wide range of securities products, all of which contribute to the development of M&A loans.

Since the promulgation of the Guidelines which have legalized the M&A loan business, some banks and relevant institutions have attempted to engage in the new business. For example, on 25 December 2008, the Shanghai United Assets and Equity Exchange reached a cooperation agreement with the Industrial and Commercial Bank of China, Shanghai Branch, and Bank of Shanghai to put together an M&A loan package of RMB10 billion. On 6 January 2009, the China Beijing Equity Exchange and the Industrial and Commercial Bank of China, Beijing Branch, signed a framework cooperation agreement with Beijing Capital Co., Ltd., which provided the first M&A loans under the Guidelines.

Removing restrictions on M&A loans has considerable impact on the development of both the M&A market and banking industry in China. However, in practice, such development is also affected by a number of factors, such as financing demand in the domestic market and the banks' risk control abilities. Thus, how exactly the Guidelines and removal of the M&A loan restrictions can help develop China's M&A market and enterprises resolving financing problems in M&A will depend on further clarification of the relevant provisions as well as the precedent of the related cases.

**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**<br>Tel: (86 21) 3135 8686<br>David.Yu@llinkslaw.com | **Wayne Chen**<br>Tel: (86 10) 6655 5050 - 1022<br>Way.Chen@llinkslaw.com |
| **Ming Zhang**<br>Tel: (86 21) 3135 8777<br>Ming.Zhang@llinkslaw.com | |