Red State Approval

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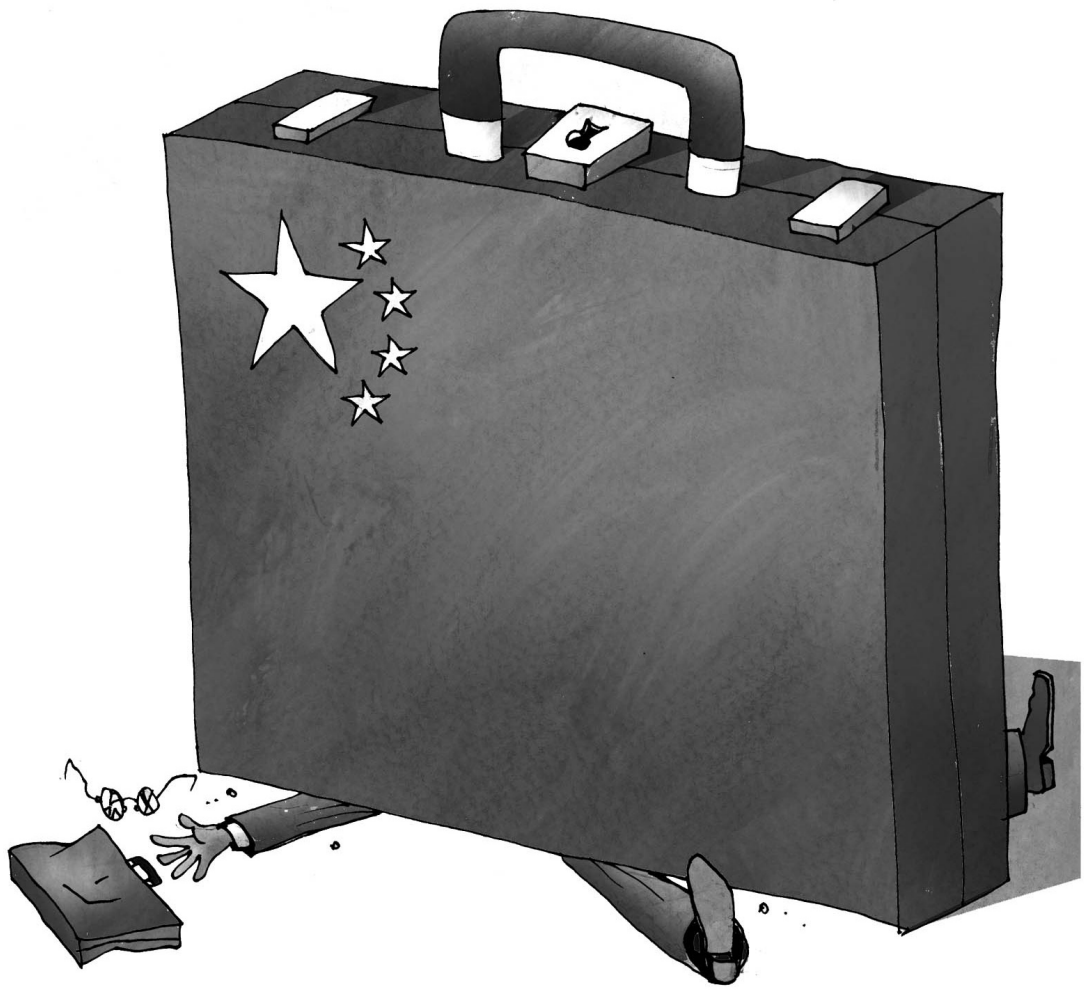

The many aspects of doing business in China can be colorful and unpredictable. Less unpredictable is the pervasiveness and substantial degree to which the government gets involved in normal business activities in China. Government approvals are arguably the most challenging aspect for foreign investors of completing a deal in China. In today's circumspect economic climate, all eyes are on a few high-profile proposed acquisitions by U.S. and other non-Chinese investors in China, as the parties tackle Chinese governmental approvals required to give legal effect to the transactions. It's normal to come away after reading press and other reports of recent deals with the impression that the regulatory hurdles to completing a deal in China are insurmountable. The Carlyle Group's cessation of a proposed acquisition of Xugong, a state-owned construction machinery producer is thought to have been caused largely by the Chinese authorities requiring Carlyle to reduce its proposed stake in Xugong more than once. Coca-Cola's proposed acquisition of the Huiyuan fruit juice company is being watched closely, as it involves the first merger control filing by a foreign acquirer under a refined anti-monopoly review mechanism. The transaction may potentially also require approval for a change in control of a well-known trademark or long-standing Chinese brand.

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The complexities of navigating China's approval system for foreign investment and foreign acquisitions are well known to U.S. companies and investors that have undertaken or considered doing a transaction in China. The number of approvals potentially required for a foreign acquisition have increased significantly in the last five years, as a result of new legislation being added to the approval framework, as well as implementing rules and guidelines being issued to flesh out existing laws and regulations.

An acquisition by a foreign (non-Chinese) party of Chinese assets or equity is potentially subject to six or more types of government approvals, including: project pre-approval from the National Development and Reform Commission, the authority in charge of macroeconomic policy; industry-specific pre-approval for foreign investment in certain industries and sectors, such as pre-approval of the State Administration for Industry and Commerce for acquisitions in the advertising business or pre-approval of the Ministry of Transportation for acquisitions in roads and transportation services; and confirmation of the valuation of the transaction and approval of the State Asset Supervision and Administration Commission if state assets or interests are involved. Prior to commencing negotiations of an acquisition of state assets or equity, the proposed acquisition must also be placed on the relevant State Asset Exchange Center's public bidding system and the intended purchaser confirmed as the final prospective purchaser before negotiations can proceed; foreign investment approval from the relevant branch of the Ministry of Commerce, which involves an examination of the industry and any applicable restrictions on foreign investment, share of foreign ownership, business scope, the terms of definitive agreements, labor issues and other aspects of the foreign acquisition; clearance from the Ministry of Commerce at the national level if the acquisition will result in the transfer of a controlling interest in a domestic company in key industries with an actual or potential effect on national economic security, or of a company with a famous trademark or a long-standing Chinese name; and anti-monopoly clearance by the anti-monopoly enforcement authority. After obtaining the requisite approvals, the acquisition must also be registered with the State Administration of Industry and Commerce and a new business license obtained to reflect changes to the target company brought by the acquisition.

Other approval requirements apply if the acquisition involves a company listed on a Chinese stock exchange or if the acquisition will be structured through a special purpose vehicle established by a Chinese company or Chinese individual.

Investors looking to make acquisitions in the high-tech sector are not automatically exempted from any of the above approval requirements. However, the nature of transactions in the high-tech sector as well as Chinese government policies encouraging investments in high, new technologies, often mean a smoother path to approval for deals in the high-tech sector.

The first characteristic of transactions in the high-tech sector in China is that they often fall below thresholds for requiring approval from national level authorities. National level approval processes are usually more time consuming and demanding than their lower-level counterparts. The National Development and Reform Commission and the Ministry of Commerce can, and do, delegate approval authority to its provincial and lower counterparts according to approval thresholds set by regulation. The approval thresholds consist mainly of the classification of the industry of the target company and the amount of total investment (paid-in equity and permitted borrowings) in the target company. National-level National Development and Reform Commission and Ministry of Commerce approval are required for "encouraged" projects with total investment of $100 million and more; and "restricted" projects with total investment of $50 million or more. Provincial or lower-level National Development and Reform Commission and Ministry of Commerce approval will suffice for "encouraged" industry transactions with total investment of less than $100 million; and "restricted" projects with total investment of less than $50 million. For projects involving a total investment of $500 million or more, the National Development and Reform Commission will seek the approval of the State Council before issuing its approval. There are special situations where national-level Ministry of Commerce approval may be required notwithstanding the amount of total investment and classification of foreign investment, for example, if the direct parent of the target company will be an offshore holding company controlled by a Chinese company or individual.

The classification of projects as "encouraged" or "restricted" can be found in China's macroeconomic planning tool for foreign investment, the Catalog for Guiding Foreign Investment in Industry. The catalog specifies business activities in which foreign investment is "prohibited," "restricted" or "encouraged." Anything not listed under any of these three categories is "permitted." The vast majority of high-tech development and production activities are classified as encouraged or permitted. Notable exceptions include the effective prohibition (outside the catalog) of foreign investment in the production of encryption technology, as China only allows encryption products made by state-authorized institutions to be made and sold in China. In the e-commerce space, non-Chinese companies and investors should be aware that a value-added telecoms services operating permit is required for the operation of e-commerce Web sites hosted on servers in China, and the permit can only be granted to a business operator with no more than 50 percent of foreign ownership. However, by and large, acquisitions in target companies engaged in computer software, integrated circuit design, semiconductor manufacturing, equipment used in semiconductor manufacturing, communications networking equipment and other information technology products will be considered "encouraged" or "permitted."

These classifications, combined with the fact that targets in the high-tech sector often have lower total investment amounts and acquisitions involve smaller cash infusions relative to other industries, mean high-tech transactions often avoid ministry-level approvals.

Secondly, transactions in the high-tech sector are less likely to trigger the approvals required for changes of control in companies in key industries with impact on national economic security or changes of control over a well-known trademarks and long-standing Chinese brands. The government is creating a joint acquisition security review committee to implement this approval requirement, consisting of the Ministry of Commerce, the National Development and Reform Commission and other agencies. It is thought that this committee may be similar in nature to the U.S. Treasury's Committee on Foreign Investment in the United States. However, it is unclear whether the scope of review of the Chinese committee will be further defined and whether the committee will provide clear guidelines and filing criteria. There is concern that if the committee will examine acquisitions on a case-by-case basis, that this will allow substantial administrative discretion and opportunities for opposition by domestic competitors. There have been various signals from the government that equipment manufacturing industries will be deemed to impact national security, including the "Certain Opinions Concerning Accelerated Development of the Equipment Manufacturing Industry" issued by the State Council on June 28, 2006, as well as the outcome of Carlyle's proposed acquisition of the Xugong construction equipment company. Thus far, there have been few indications of any industries in the high-tech sector being deemed as impacting national economic security.

As the high-tech industry in China is still in its early stages relative to other industries, there are also relative few Chinese companies whose trademarks have been designated "well-known" or who have long-standing Chinese brands. While Lenovo and Huawei are world famous, the Chinese software and high-tech parks are teeming with lesser-known companies that are potential acquisition targets.

Another factor in favor of high-tech transactions is the unmistakable endorsement at all levels of the Chinese government for advancing the technology of China's industries.

One manifestation of the encouragement policies is in the survival of tax incentives for foreign-invested enterprises (and extending them to domestic enterprises) in the high-tech sector. Recent tax reform removed the income tax holidays and other incentives that were formerly available to a broad range of foreign invested enterprises engaged in production. The incentives that remain are being granted to companies (whether foreign-invested or domestic) in specific industries, most notably to companies certified as engaged in high and new technologies. To be certified as such, companies must be engaged in electronic information technology, biological and medical technology, aviation and space technology, new materials technology, high-tech services, new energy and energy conservation technology, resources and environmental technology and transformation of traditional sectors through new and high technology, as well as satisfy other criteria.

To the extent the Ministry of Commerce, the National Development and Reform Commission and other government approvals outlined below involve government discretion; that discretion should be exercised in line with central government policy encouraging foreign investment in high-tech companies.

For the reasons outlined above, the approval rate for acquisitions in the high-tech sector is often higher than in other industries. Technology-related acquisitions have an additional set of regulatory and legal issues to address, namely those related to inflows and outflows of technology to and from China. Worthy of separate discussion, the technology import and export regime in China controls cross-border movements of technology to varying degrees depending on the classification of the technology. In most cases, the controls do not hamper transactions but should be complied with to ensure the transaction is legally and practically enforceable.

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