

Best Practices in Corporate Structuring and Consolidation

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Legal Framework of FIE Corporate Reorganization in China

➤ Two Intentionally Missing Pieces of M&A Regulations

- Applicable Law for FIE Share Transfer
 - “Domestic Enterprise” and “Domestic Company” Distinguished under Article 2
 - Provisions on Change of Shares of Foreign Invested Enterprise

- Applicable Law for FIE Merger and Spin-Off
 - Article 44 of General Principles of Civil Law
 - Provisions on Merger, Consolidation and Spin-Off of Foreign Invested Enterprise
 - Provisions on Domestic Investment of Foreign Invested Enterprises

Reorganization Models

➤ Corporate Reorganization Defined (Caishui (2009) No. 50)

- “Corporate reorganization” means any transaction other than in the ordinary course of business that fundamentally changes the legal structure or economic structure of the company, including:
 - 1) Change of Legal Form: (i) registered name; (ii) registered address; (iii) organizational form
 - 2) Debt Restructure: concessionary arrangement reached between creditors and debtor (principal reduction and repayment deferral)
 - 3) Equity Acquisition is a transaction in which the acquiring entity (the “Acquiring Entity”) to purchase the share of target entity (the “Target”) for the purpose of obtaining control over the Target with equity, non-equity or any combination thereof as consideration.

Reorganization Models

➤ Corporate Reorganization Defined

- 4) Assets Purchase is a transaction in which the transferee/purchaser entity (the “Transferee”) to purchase the substantial portion of the operation assets of the transferor/seller entity with equity, non-equity or any combination thereof as consideration
- 5) Merger is a transaction in which one or more entity (the “Merged Entity”) transfers all of its assets and liabilities into an existing or new entity (the “Surviving Entity”) in exchange for equity of the Surviving Entity, non-equity or any combination thereof as consideration.
- 6) Spin-Off is a transaction in which one entity (the “Spin-Off Entity”) spins off or otherwise transfer all or part of its assets to an existing or new entity (the “Spun-Off Entity”) in exchange for equity of Spun-Off Entity, non-equity or any combination thereof as consideration.

Reorganization Models

➤ Models

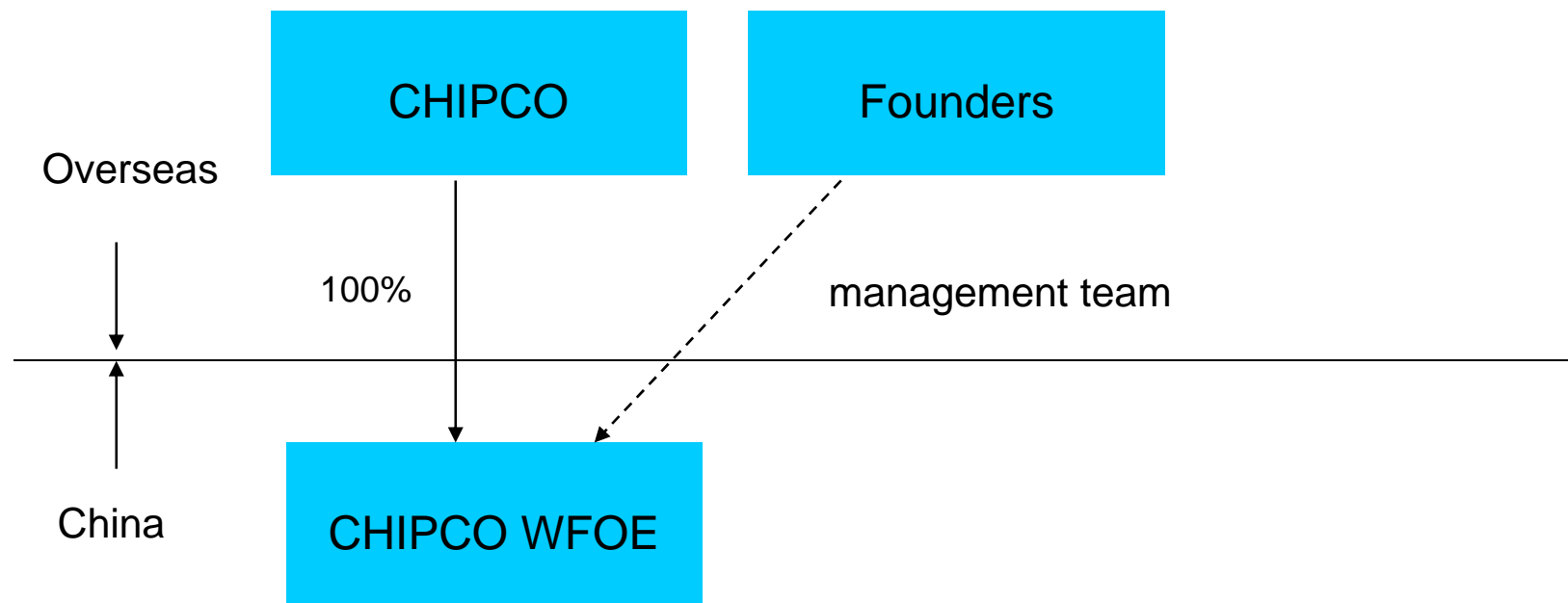
■ Merger and Consolidation

- FIE merger described
- Merger and consolidation distinguished
- Merged Entity includes domestic enterprise
- Surviving FIE must be qualified for foreign investment under FIE Investment Regulations
- Subject to industrial policy clearance, approval and registration requirements
- Registered capital of surviving FIE and shareholding calculation
- Date of establishment of surviving FIE to be carried over
- “Bulk sale” notice required

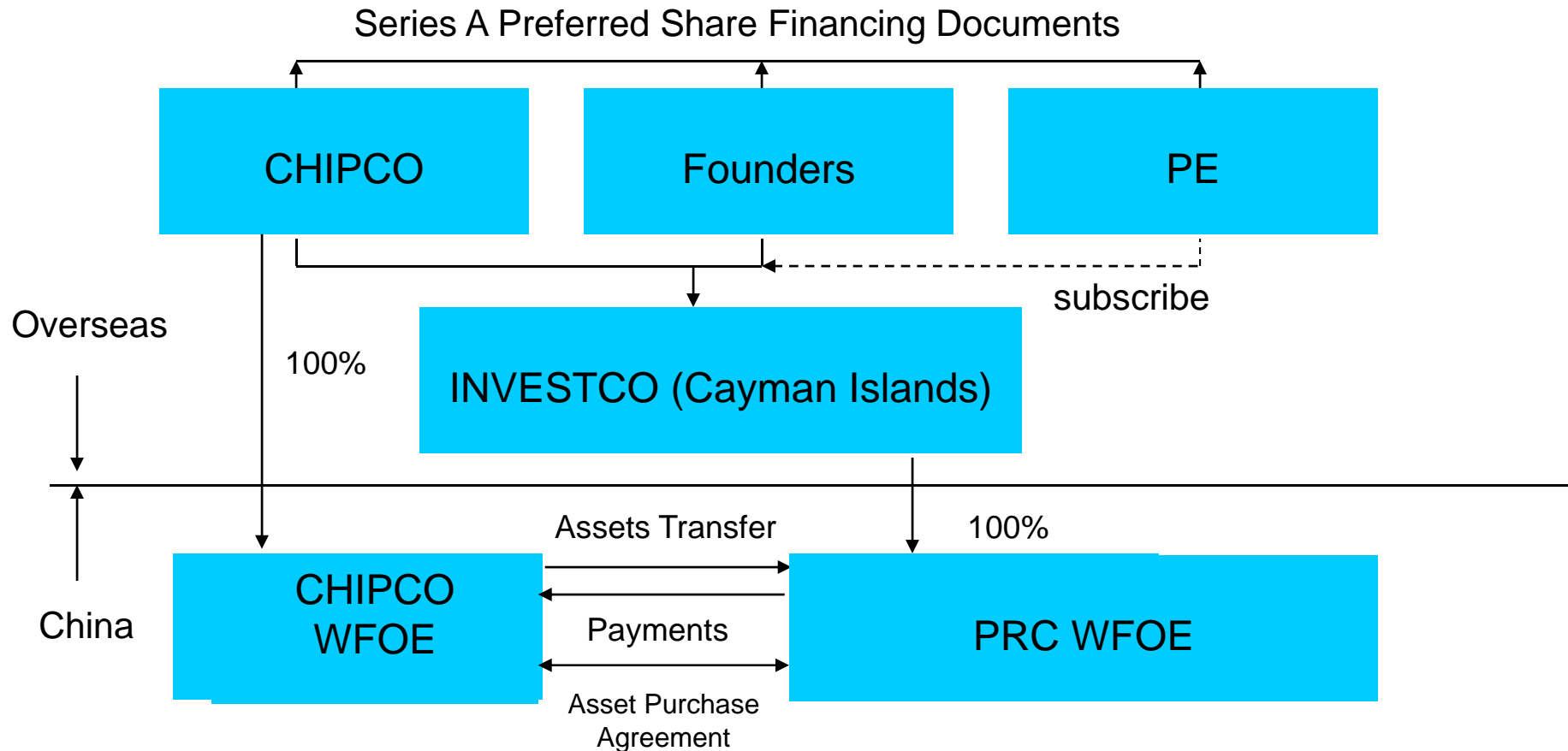
Reorganization Models

➤ Models

- Spin-Off with Private Equity Investment (illustrated)



SPIN-OFF WITH PRIVATE EQUITY INVESTMENT



- (1) CHIPCO and Founders to incorporate INVESTCO in Cayman Islands.
- (2) CHIPCO, Founders and PE to enter into Series A Preference Share Financing Documents, whereby the investors subscribe Series A Shares of INVESTCO.
- (3) INVESTCO to establish an operating WFOE in China.
- (4) CHIPCO WFOE to enter into Assets Purchase Agreement with WFOE.
- (5) Pursuant the APA, CHIPCO WFOE spin-off assets pertaining to certain product line to WFOE.

Reorganization Models

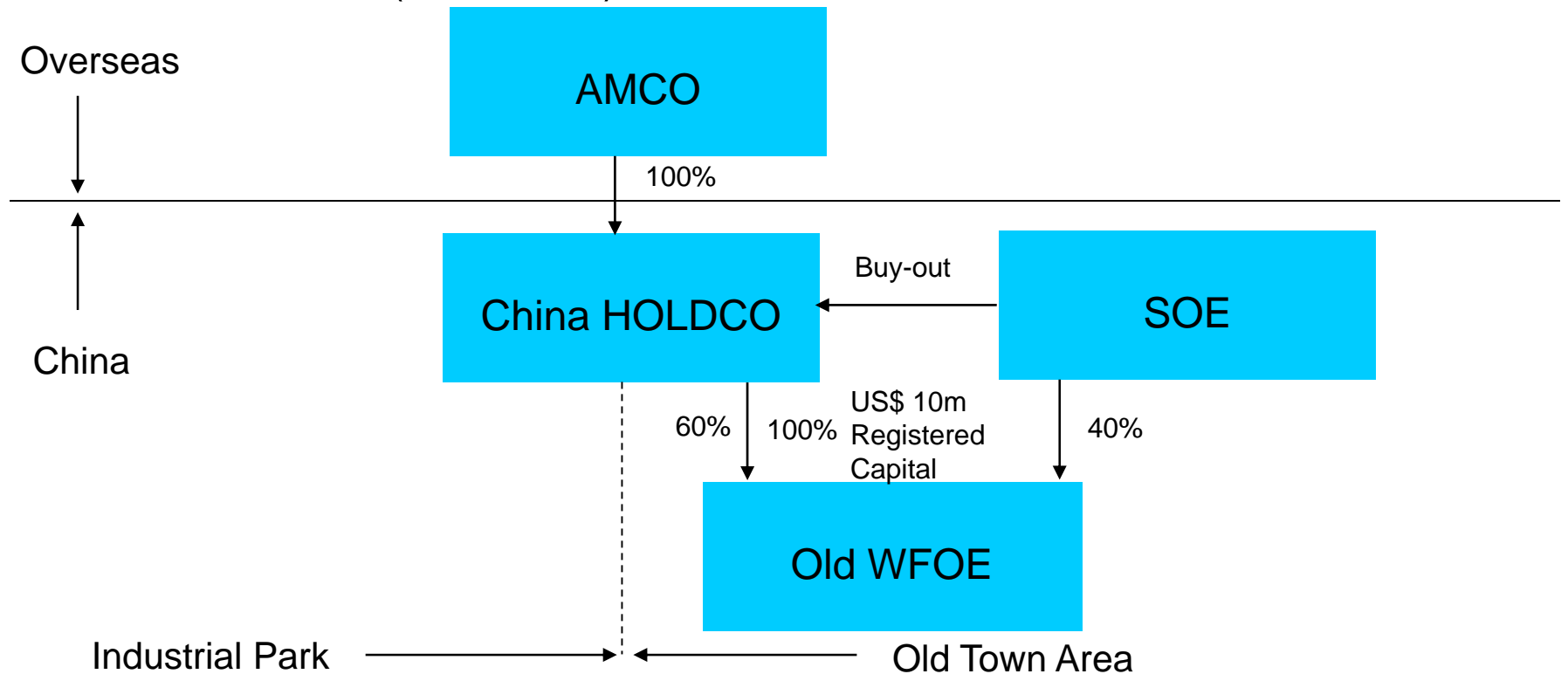
➤ Models

- Spin-Off with Private Equity Investment
 - Spin-off operation assets is permitted and practical
 - Spin-off Entity must be qualified for foreign investment
 - Tax consequence compared: foreign shareholder purchase and “drop” vs. WFOE-to-WFOE purchase
 - “Bulk sale” notice required

Reorganization Models

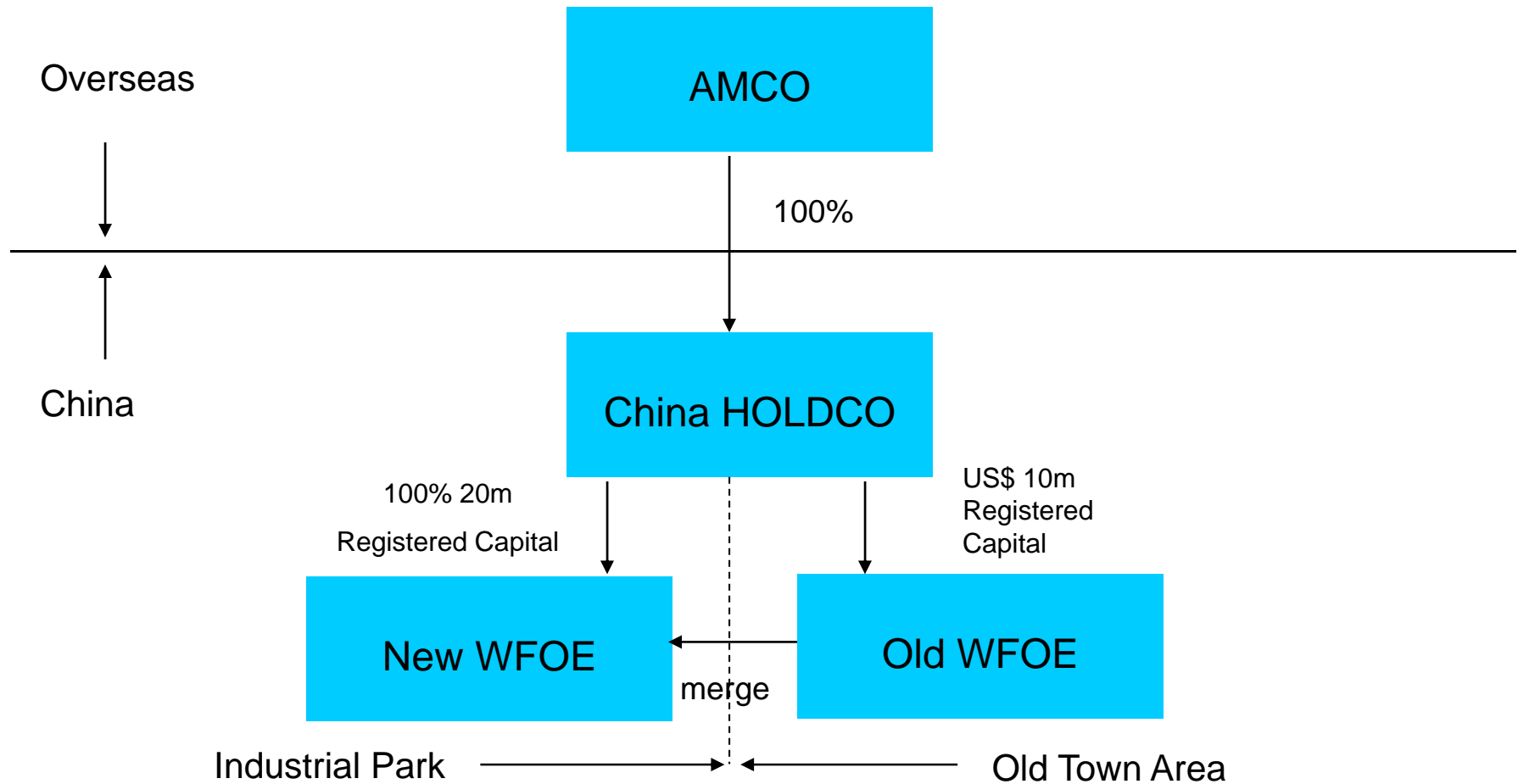
➤ Models

■ Relocation (illustrated)



① China HOLDCO to buy-out SOE's equity in the JV.

RELOCATION TRANSACTION DIAGRAM



② China HOLDCO to set up a New WFOE in Industrial Park.

③ New WFOE to merge Old WFOE.

Reorganization Models

➤ Models

■ Relocation

- Leaving grantee of land-use right open pending structuring
- Often a 3-in-1 or 2-in-1 transaction requiring parallel agreements
- Build in conditions precedent and assure simultaneous closings
- Coordinate payment schedules for “0” cost relocation
- Environmental liability cut-off

Reorganization Models

➤ Models

- Required Changes Following International M&A
 - No action required if foreign shareholder survives
 - Change of shareholder is required if foreign shareholder is merged or dissolved
 - “Concentration” review is required if the threshold is triggered

Issues in Structuring the Transactions

➤ Maximizing the Tax Benefits

- Limited Tax Holiday Benefit under New Corporate Income Tax Law
 - Unexpired tax holiday must start running on January 2008
 - Preferential tax rate phase-out
 - Regardless, certified Hi-Tech FIEs remain entitled to tax holiday of 3 year exemption and 3 year 50% reduction

- Tax Reform of 2009 (VAT and BT)
 - VAT will be imposed on disposition of used fixed assets
 - Business Tax will be imposed on transfer of intangible assets except for qualified technologies

Issues in Structuring the Transactions

➤ Maximizing the Tax Benefits

■ Special Tax Treatment on Relocation

- In case of replacement, the amount allowed to offset the replacement costs is the sum of (i) proceeds of compensation received, **PLUS** (ii) proceeds of sales of various miscellaneous fixed assets; **MINUS** the sum of (ii) depreciated residue value of removed fixed assets, and (iv) sales costs of miscellaneous fixed assets.
- In case of no replacement, the taxable gain is the product of the sum of (i) proceeds of compensation received; and (ii) proceeds of sales of various miscellaneous fixed assets; **MINUS** the sum of (ii) depreciated residue value of removed fixed assets, and (iv) sales costs of miscellaneous fixed assets.

Issues in Structuring the Transactions

➤ Maximizing Tax Benefits

■ Transfer Between Affiliates at Investment Costs Permitted

- Based on Tax Notice Guoshuihan (1997) No. 207, for legitimate corporate reorganization, the transfer of shares of an FIE could be made at cost with no income tax implications provided that (i) the transferor is a foreign shareholder and (ii) the transfer does not result in an ultimate change of ultimate ownership of the corporate group.

Issues in Structuring the Transactions

➤ Accounting Treatment/Loss Carry Over

■ Ordinary vs. Special Treatment

Ordinary Treatment	Special Treatment
Transferred at fair market value	Transferred at book value
Gain/loss recognized at transfer	No Gain No Loss
Changed tax base	Tax base unchanged

■ Conditions for special treatment

- Within direct 100% group
- Reasonable commercial purposes and main purpose not for reduction, avoidance or deferral of tax
- Minimum of assets or equity subject to reorganization
- No material change of operating activities within 12 consecutive months after restructure
- Minimum consideration in form of equity
- Original main shareholders that obtain consideration in equity must undertake not to transfer acquired equity within 3 years after restructure

Issues in Structuring the Transactions

- **Leverage your position and ally with local government**
 - Reorganization often requires multi-departmental coordination
 - Identify who is in charge and a better position for daily coordination
 - Leverage your image, benefit to local community and investment commitment for assistance and maximum benefits

Issues in Structuring the Transactions

➤ Change of Labor Contract in Restructuring

- No termination no compensation for merger and spin-off
- Assets purchase may requires termination and payment
- Leverage of the benefit with new company for a negotiated transfer of labor contracts

Issues in Structuring the Transactions

➤ Negotiate for Accounting and Sharing the Costs

- Rationale suggests the costs pertaining to YCS to be shared with seller

- Scenario one: equity transfer

$$\text{Reserve} = \text{total compensation} \times \frac{\text{YCS for Seller}}{\text{total YCS}}$$

- Scenario two: Chinese JV partner buy-out

$$\text{Deduction} = \text{total compensation} \times \frac{\text{YCS for Seller}}{\text{total YCS}}$$

$$\left(\frac{\text{YCS for Partner}}{\text{total YCS}} + \frac{\text{YCS for JV}}{\text{total YCS}} \right) \times \text{Chinese partner equity \%}$$

- Others requiring accounting include: accrued vacation days / 13th month wage

Issues in Structuring the Transactions

➤ Avoid Unwanted “Stranger”

- Right of first refusal (“ROFR”)
- Reconcile ROFR and SASAC Requirement
 - SASAC Requirement (SASAC/MOF Decree (2003) No. 3)
 - Shanghai practice
 - New Guidance of SASAC
- ROFR in Judicial Proceeding
 - Seizure of equity and judgment enforcement
 - ROFR “protected”
 - Corporate registrar follows court order

THANK YOU!

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