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The Legal 500 Country Comparative Guides

China

MERGERS & ACQUISITIONS

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This country-specific Q&A provides an overview of mergers & acquisitions laws and regulations applicable in China.

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CHINA
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1. What are the key rules/laws relevant to M&A and who are the key regulatory authorities?

The key rules governing M&A activity in the PRC include:

- the *Company Law*, the *Contract Law* and various judicial interpretations of the Supreme People's Court;
- the current foreign investment regulations, including the *Foreign Investment Law* and its implementing rules, the *Catalogue of Industries for Encouraging Foreign Investment (2020 Edition)*, the*Special Administrative Measures for Access of Foreign Investment (Negative List) (2021 Edition)* and the *Special Administrative Measures (Negative List) for Foreign Investment Access in Pilot Free Trade Zones (2021 Edition)*, together with their implementing rules;
- Chinese outbound investment regulations;
- PRC foreign exchange laws and regulations;
- Company registration laws and implementing rules;
- the *Enterprise Income Tax Law* and its implementing rules; and
- anti-trust related laws, including the *Anti-Monopoly Law* and the *Guiding Opinions of the State Administration for Market Regulation on the Declaration of Concentration of Business Operators (2018 Revision)*.

In general, the key regulatory bodies governing M&A activity in the PRC include:

- The State Administration for Market Regulation (SAMR), which is a market watchdog responsible for regulating overall market activities, including implementation of competition and anti-monopoly laws and policies.
- The Ministry of Commerce (MOFCOM), which is responsible for regulating domestic and cross-border trade and economic cooperation, including outbound investment by Chinese companies and inbound investment by foreign investors.
- The National Development and Reform Commission (NDRC), which is responsible for formulating and implementing national or regional strategic economic planning and, together with MOFCOM, reviewing key investment projects.
- The China Securities Regulatory Commission (CSRC), which is responsible for regulating securities markets, including primary and secondary market securities offerings and trading activities involving publicly held companies.
- The State-owned Assets Supervision and Administration Commission (SASAC), which is responsible for supervising the management and operations of all State-owned enterprises in non-financial sectors.
- The State Administration of Foreign Exchange (SAFE), which is responsible for implementing currency control regulations that limit the convertibility of the country's official currency and foreign currencies in commercial activities.

In addition, industry-specific regulators, such as the Ministry of Industry and Information Technology (MIIT) on telecoms and IT sectors, Ministry of Education, the National Medical Products Administration, the National Radio and Television Administration and the National Press and Publication Administration may promulgate rules governing M&A activity in specific industries.

2. What is the current state of the market?

According to data from PwC, China M&A volumes surged to a new record of 12,790 transactions in 2021 – up 21% from the previous year – while deal values fell 19% to $637bn from the previous year's record level.

China M&A surged in in terms of volume thanks to the dual-circulation policy and ongoing industrial upgrade programs. The digital economy, new energies and green development will continue to drive M&A transactions in the future. The various economic dislocations associated with Covid-19 and geo-political trends will also give rise to domestic transaction activity. Corporate reorganizations and changes in strategy will be a further driver of deals, according to PwC.

3. Which market sectors have been particularly active recently?

The leading sectors for M&A activity in 2021, by number of deals, were manufacturing, the high technology and information industry, healthcare, financials and enterprise services. Industries such as transportation, construction, retail, hospitality, mining and real estate experienced high degrees of disruption and volatility throughout the pandemic.

4. What do you believe will be the three most significant factors influencing M&A activity over the next 2 years?

Strict antitrust merger scrutiny over M&A activities.

On 23 October 2021, the *Draft Amendment to the Anti-Monopoly Law of the People's Republic of China* (the "Draft Amendment") was published for public comments. It is anticipated that business concentration filings (aka merger control filings) will become an important obligation on the part of the acquirer, in an M&A transaction, that aims to obtain control of the target company. More noteworthy implementing rules and guidance followed the Draft Amendment. On 10 July 2021, SAMR published an anti-monopoly review decision and prohibited the merger between Huya Inc. and Douyu International Holdings for business concentration concerns.

As of 31 December 2021, there were more than 90 cases in which SAMR imposed penalties, for a total amount of more than CNY 61.35 million, against business concentration violations. Most cases involved business operators in Internet platform sectors and using VIE structures.

In some cases, venture capital fund investors of the acquirors were found to have "joint control" of the target companies and, without requisite merger control filings, to have failed to comply with anti-monopoly law. In around 50 cases, the venture capital investor's equity ownership was 30% or less. In around 10 cases, it was under 10%.

These enforcement cases indicate that ownership percentage in target companies is only one of many factors in determining whether one business operator has control of another business operator. Other factors include contractual voting arrangements, act-in-concert agreements, veto powers and other special corporate governance arrangements. Given the substantial discretion of anti-monopoly authorities in interpreting the law, parties to M&A transactions are strongly advised to carefully evaluate whether the element of control exists, particularly when the equity ownership share is close to or above 10% in an M&A transaction.

Developments in cybersecurity review regulations.

2021 witnessed a series of laws promulgated and enforcement actions taken in the cybersecurity space, the most consequential of which include (1) *Data Security Law* and (2) *Personal Information Protection Law*. These laws, along with the pre-existing *Cybersecurity Law*, have become the cornerstone legislation addressing cybersecurity issues in China. In the meantime, detailed implementation rules were also released in 2021, all together having a great impact on M&A transactions in the Internet industry. On 2 July 2021, the Cyberspace Administration of China ("CAC") announced a cybersecurity investigation against "Didi Chuxing", the largest ride-share app operator in China. Around the same period, the CAC also initiated cybersecurity reviews of three other big Internet platform operators.

The Data Security Law became effective on 1 September 2021 and requires that all data handlers, including operators of critical information infrastructure, whose data handling activities affect or may affect the national security must undergo national security review.

Further, the R*egulation on Network Data Security Management (Draft for Comment)* ("*Draft Data Security Regulation*"), published on 14 November 2021, provides that cybersecurity review by government authorities is required in any of the following circumstances:

- a merger, reorganization or division by an Internet platform operator who has collected a substantial amount of data resources that concern national security, economic development or public interest, if such merger, reorganization or division will or may affect China's national security;
- an IPO in foreign capital markets by a data processor who processes personal information of more than one million individuals;
- a data processor's Hong Kong IPO that will or may affect China's national security; or
- other data processing activities that will or

may have an impact on national security.

The *State Council Measures on the Administration of Overseas Securities Offering and Listing by Domestic Companies (Draft for Comment)* ("*Draft Overseas Listing Measures*"), published on 24 December 2021, state that domestic companies that seek to list securities in overseas markets must institute a sound system, and take necessary measures, to protect state secrets and safeguard national security and public interests. Article 8 of the *Draft Overseas Listing Measures* further states that domestic companies that seek to list securities in overseas markets must comply with national security laws and regulations with respect to foreign investment, cybersecurity and data security, and earnestly fulfill their obligations to protect national security, including completing a national security review, if necessary.

The *Cybersecurity Review Measures* was promulgated on 28 December 2021. It expands the scope of cybersecurity review and incorporates a number of measures proposed in the *Draft Data Security Regulation*. For example, it subjects all data processors who collect and generate data in mainland China and whose activities may affect national security to a cybersecurity review, thereby covering both cybersecurity and data processing activities. Article 7 of the *Cybersecurity Review Measures* states that a network operator that collects personal information of more than one million users must apply to the Cybersecurity Review Office (of the CAC) for a cybersecurity review when it seeks an overseas listing (other than on the Hong Kong Stock Exchange).

When the *Draft Data Security Regulation* is eventually adopted, major M&A, reorganization or financing transactions of an Internet platform operator who possess an important and large volume of data would likely be subject to data security or cybersecurity review, which could potentially delay the transaction process, increase transaction costs and result in sharing otherwise confidential corporate information with regulators. With greater access to corporate information, regulators would be in a better position to exert influence over an Internet platform operator's operational or financing decision-making. This appears to serve the purpose of preventing future events similar to Didi's overseas IPO, which was deemed by the PRC government to have posed a risk to national security. Internet platform operators are strongly advised to pay close attention to the ongoing development of regulations in this space.

International and domestic policies under the current political environment.

In December 2021, the SEC finalized rules to implement the Holding Foreign Companies Accountable Act ("HFCA Act"). The law was enacted in 2020 in response to the inability of the PCAOB to inspect the audits of China-based U.S.-listed firms. Pursuant to this law, the SEC will ban companies from trading in the U.S. securities markets if the PCAOB is unable to inspect the audits of such companies for three consecutive years. The earliest any trading prohibitions would be imposed on a non-compliant company would be in 2024.

The SEC established procedures to identify companies (the "Commission-Identified Issuers") that have retained an accounting firm (i) that is located in a foreign jurisdiction and (ii) which the PCAOB is unable to inspect or investigate due to a position taken by an authority in the foreign jurisdiction (as determined by the PCAOB). In addition, the SEC implemented the submission and disclosure requirements under the HFCA Act by amending the relevant requirements in Forms 20-F, 40-F, 10-K and N-CSR. Further, the SEC finalized the process to prohibit the trading of the securities of such Commission-Identified Issuers as required by the HFCA Act.

In March 2022, the SEC notified five China-based public companies they could be delisted from U.S. stock exchanges if they do not allow their audits to be inspected the PCAOB.

In response to the SEC's rulemaking, the CSRC, emphasizing the importance of Chinese companies having access to the U.S. capital markets, recently stated that it had always been open to Chinese companies' choice of listing venues in compliance with the relevant laws and regulations, and that it had been proactively seeking discussions with the SEC and the PCAOB to work out a mutually satisfactory solution under the principle of "joint U.S.-China audit inspection." Calling for continued China-U.S. cooperation on audit oversight, the CSRC mentioned that "positive progress" had been made in talks on regulatory cooperation with the U.S. regulators.

In the same statement, the CSRC, denying reports of a possible ban on overseas stock listings by Chinese firms using a VIE structure, also said that it was not asking Chinese firms to drop their U.S. listing plans, and that it was aware that companies were actively working with Chinese and U.S. regulators to pursue their capital markets debut on a U.S. stock exchange. It remains to be seen whether the regulators in both countries will be able to find a path forward to resolve the long-lasting audit issue in order to prevent the exit of hundreds of China-based companies from U.S. markets.

In light of the regulatory uncertainties, companies with substantial Chinese operations seeking a listing in the

United States had better carefully evaluate the impact of both the HFCA Act and the evolving regulatory environments in their respective industries in China in order to comply with the disclosure and regulatory approval requirements in both the United States and China. China-based companies currently listed on a U.S. stock exchange are encouraged to assess opportunities to mitigate the risks of the trading prohibition under the HFCA Act, including seeking a potential “home-coming” listing in Hong Kong and other appropriate transactions.

5. What are the key means of effecting the acquisition of a publicly traded company?

The most commonly used deal structures in the acquisition of PRC public companies include share transfers by agreement, voting trusts, block trades and tender offers. Hybrid structures employing a combination of these are common too.

6. What information relating to a target company will be publicly available and to what extent is a target company obliged to disclose diligence related information to a potential acquirer?

From publicly available sources (including websites of governmental authorities), PRC investors can easily find general information on a PRC company, such as shareholding structure, corporate history, administrative penalties, on-going and concluded litigation and enforcement procedures, pledges, intellectual property registrations and filings. Public companies are also required to publicly disclose their audited financial reports and other financial information periodically, as well as material information in accordance with the listing rules and disclosure requirements of the stock exchanges. Otherwise, a target company is not generally obliged to disclose any diligence information to a potential acquiror. It is customary, however, for an acquiror to request a target company to provide as much information as possible during due diligence (typically subject to the signing of a non-disclosure agreement or a letter of intent including confidentiality clauses).

7. To what level of detail is due diligence customarily undertaken?

Some PRC investors neglect the importance of prudent due diligence and an informed decision-making process during the execution of M&A deals. Timetables can be unreasonably aggressive in a rush to close deals and save on transaction costs. This is particularly common in some early-stage investments by non-sophisticated investors, resulting in acquirors being exposed to material compliance and internal control issues as well as contingent liabilities without appropriate provisions in transaction documents. More prudent investors, on the other hand, tend to engage experienced lawyers, accountants, tax and financial advisors and other professional advisors to conduct thorough due diligence on target companies and to carefully assess relevant risks before making an investment decision. In the latter scenario, although investors may vary in terms of the level of detail in due diligence and specific industries, our general observation is that parties tend to focus more on corporate history, compliance issues and licensing of a target company, among other areas. In addition, information privacy and intellectual property issues are becoming key focuses for transactions in the TMT and life science sectors.

8. What are the key decision-making organs of a target company and what approval rights do shareholders have?

The shareholders’ meeting is typically the highest decision-making organ of a PRC company, followed by the board of directors. Subject to a company’s articles of association, typically simple majority or super majority approval by the shareholders’ meeting is required for most material corporate actions. One exception to this structure, however, is a Sino-foreign equity joint venture (EJV) established before January 1, 2020, in which there is no shareholders’ meeting, making the board of directors the highest decision-making organ. As a result, shareholders technically have no approval rights in an EJV. Further, the EJV-related laws require that certain actions be unanimously approved by the board of directors, including amendments to the EJV’s articles of association and suspension or dissolution of the EJV. All other decisions require a simple majority of an EJV’s board of directors.

However, the *Foreign Investment Law* and its implementation rules, which became effective on January 1, 2020 , replaced the laws and regulations on EJV and other foreign-funded enterprises, except that they provide a five-year transition period for existing EJVs to change the highest authority from the board of directors to the shareholders’ meeting, and change the voting mechanism accordingly pursuant to the *Company Law*.

As to investors holding a certain percentage of preferred shares, they typically request veto rights (in single or shared form) over some material actions of the target companies which may materially affect their interests, such as changes of share capital, dissolution and liquidation, mergers and changes of principal business.

9. What are the duties of the directors and controlling shareholders of a target company?

Under the *Company Law*, a director owes duties of loyalty and diligence to a target company. In a private transaction, the directors are generally required to execute the decisions of the shareholders' meeting. In an EJV, however, the directors would normally act under instructions of the shareholders who nominate them. A controlling shareholder owes duties of not impairing interests of the company and other shareholders by connected party transactions or by abuse of rights under the *Company Law*. Also, some investors attach contractual obligations to the controlling shareholders (e.g., maintain control of the company, ensure minority shareholders receive adequate compensation or provide indemnity to investors) or grant other rights to protect minority shareholders (e.g., co-sale rights).

In the acquisition of a public company, the target company's directors must make decisions and take actions in the best interest of the target company and its shareholders, and treat all competing acquirors equally and fairly in accordance with their duties of loyalty and diligence. Directors cannot set unreasonable prerequisites to the acquisition, provide financial assistance to the acquiror using resources of the target company or harm the lawful interests of the target company or its shareholders. Likewise, the controlling shareholders cannot harm the lawful interests of the target company or its other shareholders.

10. Do employees/other stakeholders have any specific approval, consultation or other rights?

Employees of a company generally have no approval right for an M&A transaction. Technically, the *Company Law* provides that a target company should consult its labor union (if applicable) and obtain opinions and suggestions from its employees when making decisions on restructuring and major issues concerning its business operations or formulating major rules, regulations and policies. However, a target company generally is under no obligation to accept the opinions of the labor union or any employee and the consultation process is therefore usually only a formality, except for some transactions involving employees of state-owned enterprises or share incentive programs of public companies.

11. To what degree is conditionality an accepted market feature on acquisitions?

The majority of M&A deals in the PRC are two-step transactions and it is generally accepted in the PRC market that certain conditions will need to be fulfilled or waived before the closing of an M&A transaction.

12. What steps can an acquirer of a target company take to secure deal exclusivity?

The acquiror can enter into an exclusivity agreement, or a letter of intent/MOU that includes a legally binding exclusivity clause with the target company and its shareholders. The definitive transaction documents often also include exclusivity clauses covering the period from signing to closing.

13. What other deal protection and costs coverage mechanisms are most frequently used by acquirers?

Usually if an up-front deposit is paid to the target company, acquirors request reverse break fees, payable by the target company and/or the sellers if the deal does not close.

14. Which forms of consideration are most commonly used?

Cash is the most commonly used consideration. An issuance of new shares of the acquiror in exchange for the equity interests of the target, i.e., share swap, or a hybrid structure of combination of cash and share swap, are also frequently used, especially if the acquiror is a public company.

15. At what ownership levels by an acquirer is public disclosure required (whether acquiring a target company as a whole or a minority stake)?

There are generally no disclosure requirements in private M&A transactions. If an investor only acquires a minority stake in a public company, then the investor is required to publicly disclose through a Simplified Report on Shareholding Change (Simplified Report) if the acquiror directly or indirectly (e.g., by way of persons acting in concert) acquires 5% to 20% of the shares in a public company and such shareholding will not result in a change of control of the target company. The Simplified Report typically includes the identity of the acquiror and all persons acting in concert, their current shareholding in the company, their history of trading the shares in the past 6 months, the purpose of their acquisition, and whether the acquiror intends to further increase its shareholding in the target company in the next 12 months.

When acquiring a controlling stake in a public company, the acquiror is generally required to publicly disclose a Detailed Report on Shareholding Change (Detailed Report). In addition to the disclosures required in a Simplified Report, a Detailed Report should include the shareholding structure of the acquiror, all persons acting in concert with the acquiror on a see-through basis, their financials from the past three years, source of funding, and their future plans to reorganize the target company. These disclosures are intended to identify the ultimate beneficial owner of the acquiror and demonstrate that the acquirer or its ultimate beneficial owner (if the acquirer is an SPV) has the economic capacity to acquire the target company without using certain types of leverage (other than bank and shareholder loans).

16. At what stage of negotiation is public disclosure required or customary?

There are generally no disclosure requirements in private M&A transactions. In a public M&A transaction, the acquirer is required to inform the target and disclose the potential transaction if the acquisition stake triggers the threshold as discussed in question 15 above via the applicable stock exchange on which the target is listed promptly upon the signing of any written agreement (even a non-binding document, such as a letter of intent). Also, even before any execution of a written agreement, in the event that the share price of the listed company fluctuates abnormally, the listed company is required to clarify whether such price fluctuation was caused by any non-disclosed material transaction, and if so, to disclose relevant information of such transaction. Thus, keeping the negotiation strictly confidential is significant for a public M&A.

17. Is there any maximum time period for negotiations or due diligence?

There is generally no time limit for negotiations or due diligence in an M&A transaction. However, if a public company is engaged in a material restructuring or acquisition transaction that is subject to the requirement on suspension of trading of its shares, the public company may not suspend trading for more than three months without consent from the applicable stock exchange.

18. Are there any circumstances where a minimum price may be set for the shares in a target company?

In a direct share transfer agreement or block trade for shares in a public company, the share transfer price cannot be lower than a percentage (typically 90%) of the company's closing share trading price on the last trade day prior to the signing of relevant agreements. For indirect share transfers (e.g., acquiring shares of a shareholder of a public company), there is no strict minimum price requirement. However, for any transaction involving state-owned shares, the transfer price should be no less than the price determined by the appraisal results of the state-owned assets. Also, for any connected transactions of a public company (such as a public company acquiring assets or shares from its connected party), the price should be determined at arm's length and be not less than the base valuation determined by an appraisal firm.

19. Is it possible for target companies to provide financial assistance?

In a private M&A transaction, there is generally no prohibition of such financial assistance, subject to approval of the general meeting and board of the target company according to the *Company Law* and articles of association of the target, as such financial assistance may constitute a related-party transaction. However, in a public acquisition, the target company is not allowed to provide financial assistance.

20. Which governing law is customarily used on acquisitions?

Where a purely domestic company is being purchased or invested in by a foreign party, the key transaction documents such as the equity joint venture contract (not applicable in a full takeover) and the articles of association of the target company must be governed by PRC law. For other cross-border M&A deals, such as outbound transactions, parties may be able to choose the laws of another jurisdiction to govern the transaction documents, subject to the *Law on the Laws Applicable to Foreign-Related Civil Relations*. The selection of the laws of a given jurisdiction to govern a share/equity purchase agreement will be determined based on several factors, including the deal structure, the nationality of the purchasing entity, the Doctrine of the Most Significant

Relationship, and the qualifications of their legal counsel.

21. What public-facing documentation must a buyer produce in connection with the acquisition of a listed company?

The buyer will need to engage a qualified financial advisor (usually a PRC investment bank) to produce a series of reports, including a Simplified Report on Shareholding Change, a Detailed Report on Shareholding Change, and an Independent Financial Advisor Report. The buyer is also required to engage PRC legal counsel to issue a number of legal opinions on the acquiror's compliance with applicable PRC laws, and on the legality of each procedure of the transaction. Inquiry letters or comment letters issued by applicable stock exchanges on the acquisition along with responses to the letters by the target, the acquiror, the financial advisor and legal counsel will be disclosed as well.

22. What formalities are required in order to document a transfer of shares, including any local transfer taxes or duties?

In a private M&A transaction, the parties will register, with the applicable local branches of SAMR and the tax authority, shareholder changes and other corporate changes of the target company (e.g., legal representative and director changes). If a foreign investor is involved, typically a filing with local SAFE or its authorized banks is required as well. If any seller is an individual, the acquiror will be required to withhold and pay to the local tax authority Individual Income Tax levied on the capital gains of the transfer on behalf of the individual seller. The parties will also be required to pay a stamp duty.

In a public M&A transaction, the parties should register the transfer of shares of the target company at the applicable branch of the China Securities Depository and Clearing Corporation Limited (CSDC).

23. Are hostile acquisitions a common feature?

No. Competitive or hostile takeovers are relatively rare in the PRC market.

24. What protections do directors of a target company have against a hostile approach?

Directors can invite a competing bidder to compete against the hostile acquiror. As directors are required to conduct independent investigations on the qualifications, credibility and intention of a hostile acquiror and analyze the tender offer terms, they may also issue a negative opinion on the offer to facilitate its rejection by shareholders.

25. Are there circumstances where a buyer may have to make a mandatory or compulsory offer for a target company?

If an acquiror intends to acquire more than 30% of the shares of a public company, or if it already holds 30% or more of the shares of a public company (e.g., by way of transfer by agreement or block trade) and intends to acquire more shares, the acquiror is required to make a tender offer to all other shareholders of the target company.

26. If an acquirer does not obtain full control of a target company, what rights do minority shareholders enjoy?

If the target company is a private entity, the minority shareholders may have veto rights over decisions of the controlling shareholder at a shareholders' meeting or over board resolutions pursuant to the target company's shareholders agreement and/or articles of association. In addition, the *Company Law* provides that the following decisions may only be adopted upon an affirmative vote of two-thirds of the total number of shareholder votes:

- amending the articles of association;
- increasing or decreasing registered capital;
- merging, diverging or dissolving the company; and
- changing the corporate form of the company.

However, a minority shareholder of a public company is not entitled to veto rights over shareholders' meetings or board resolutions due to the one-share-one-vote rule. In addition, the Science and Technology Innovation Board of the Shanghai Stock Exchange (STAR Market) permits dual-class voting, which is commonly used in other capital markets, subject to certain market cap and revenue thresholds.

27. Is a mechanism available to compulsorily acquire minority stakes?

If a company's shareholders' meeting has adopted a resolution to merge or divide the company, a dissenting minority shareholder may require the company to repurchase all shares held by the dissenting minority shareholder.

In a public acquisition, if an acquiror has obtained a controlling stake in a listed company resulting in the public float of the listed company being below 25% (or 10%, if the total number of shares is 400 million or more), then, upon consent of the applicable stock exchange, the acquiror is required to acquire the remaining minority shares and delist the target company.

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