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Direct Contributions of Equity Interests as Registered Capital: Now Available to Foreign-Invested Enterprises in China

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On September 21, 2012, the Ministry of Commerce (“**MOFCOM**”) promulgated the *Interim Provisions of the Ministry of Commerce for Equity Contribution in Relation to Foreign-Invested Enterprises* (商务部关于涉及外商投资企业股权出资的暂行规定) (the “**Provisions**”), effective as of October 22, 2012. The Provisions explicitly permit a foreign or domestic investor to contribute equity interests held by such investor in another PRC domestic company or foreign-invested enterprise (an “**Equity Source Company**”) to a targeted foreign-invested enterprise (a “**Target FIE**”) as such Target FIE’s registered capital.

BACKGROUND

Traditionally, only cash, tangible assets such as equipment, intangible assets such as intellectual property rights, and land use rights could be contributed as capital with respect to a foreign-invested enterprise (an “**FIE**”).¹ The PRC government has generally been conservative in accepting any non-cash assets as a source of capital, mainly because of the difficulty involved in ascertaining the value of non-cash assets, particularly shares or equity interests, whose prices fluctuate from time to time. Due to this concern, the *PRC Company Law* (中华人民共和国公司法) (“**Company Law**”) sets forth a cap for any non-cash capital contribution that the aggregate amount of any such contributions in a limited liability company cannot exceed 70% of its registered capital. It was not until 2005 that the Company Law was amended to permit shares or equity interests as a possible source for capital contribution purposes,² and then in 2009 the State Administration for Industry and Commerce (“**SAIC**”) adopted a set of rules³ (the “**SAIC Measures**”) purported to provide an administrative registration guidance in connection with the contribution by an investor of equity interests to a company as its registered capital. However, pursuant to PRC FIE laws and regulations, matters relating to capital contributions in FIEs are subject to MOFCOM’s approval. Absent MOFCOM’s acceptance of equity interests as a source of capital contributions with respect to FIEs, it would be difficult to apply the SAIC Measures to FIEs, as a practical matter.

Given the general conservative position of the PRC government in terms of what can be contributed as the registered capital of a company in the PRC, onshore mergers or acquisition transactions, especially, those involving FIEs, have been

¹ See Article 27 of the *PRC Company Law* (中华人民共和国公司法), Article 5 of the *Law of the PRC on Sino-Foreign Equity Joint Ventures* (中华人民共和国中外合资经营企业法), Article 8 of the *Law of the PRC on Sino-Foreign Cooperative Joint Ventures* (中华人民共和国中外合作经营企业法), Article 22 of the *Implementing Regulations of the Law of the PRC on Sino-Foreign Equity Joint Ventures* (中华人民共和国中外合资经营企业法实施条例), Article 18 of the *Implementing Rules of the Law of the PRC on Sino-Foreign Cooperative Joint Ventures* (中华人民共和国中外合作经营企业法实施细则), and Article 25 of the *Implementing Rules for the Law of the PRC on Wholly Foreign-Owned Enterprises* (中华人民共和国外资企业法实施细则).

² See Article 27 of the *PRC Company Law* (中华人民共和国公司法).

³ See the *Administrative Measures on Registration of Capital Contribution by Equity* (股权出资登记管理办法), effective on March 1, 2009.

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largely cash-intensive. MOFCOM, in particular, has been very reluctant to embrace the concept of “share swap.” Although under the *Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors* (关于外国投资者并购境内企业的规定) (widely known as “**Circular 10**”), MOFCOM expressly permits a foreign investor to use an offshore company’s shares as consideration to acquire an equity interest in an onshore company, it rarely approves any cross-border transaction using such share swap structure in practice.

By promulgating the Provisions, MOFCOM brings its regulations governing capital contributions in FIEs in line with the Company Law and the SAIC Measures, which, if implemented fully, could help encourage more onshore M&A transactions involving FIEs using equity swaps or share swaps. Although the Provisions do not currently apply to cross-border share swap transactions, we hope that the successful implementation of the Provisions on onshore M&A involving share swap transactions would encourage MOFCOM to change its current negative position toward cross-border share swap transactions.

HIGHLIGHTS OF THE PROVISIONS

A number of points under the Provisions are worth noting, and these are highlighted as follows:

Qualitative Requirements with Respect to Contributable Equity Interests

An equity interest to be contributed to a Target FIE as its original or increased registered capital must be transferable free of any ownership defects or disputes or any other encumbrances. Specifically, an equity interest is prohibited from being contributed to a Target FIE if:

- the registered capital of the Equity Source Company has not been fully paid up;
- such equity interest is encumbered by a pledge;
- such equity interest is subject to a freezing order;
- such equity interest is not transferable according to the articles of association of the Equity Source Company (i.e., right of first refusal of the shareholders);
- the Equity Source Company (in the case of an FIE) failed to participate or pass the joint annual inspection in the preceding year;
- the Equity Source Company is a property-development enterprise, foreign-invested holding company, or foreign-invested venture capital enterprise;
- regulatory approvals required for transfer of such equity interest have not been obtained; or
- the transfer of such equity interest is prohibited pursuant to relevant laws and regulations.

In addition, it is also clearly stated that contributing equity interests in an FIE cannot be used by an investor to circumvent the existing legal and policy restrictions on foreign investments.

Valuation Requirements

The Provisions require that, prior to being contributed to a Target FIE, the value of the concerned equity interest must be appraised by a valuation firm qualified in the PRC. The appraised value of the equity interest concerned shall serve as the basis for the determination of the “contribution price” and the “contribution value” of the concerned equity interest.

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Under the Provisions, the “contribution price” refers to the transaction price in relation to the concerned capital contribution transaction as may be agreed to by the relevant parties. The “contribution value” refers to the amount representing the value of the equity interest in the total registered capital of the Target FIE and such value must not exceed its appraised value. Apparently, this requirement is intended to prevent any false or insufficient capital contribution in a Target FIE. As a related requirement, consistent with the Company Law, the Provisions state that the sum of (i) the aggregate contribution value of any equity interests contributed and (ii) the value of the other forms of non-monetary capital contributions made by all shareholders in the Target FIE shall not exceed 70% of the total registered capital of the Target FIE. In other words, at least 30% of the registered capital of any FIE must be contributed in cash.

Approval Requirements and Other Requirements

- **Approval Authority.** MOFCOM or its provincial-level counterpart at the location of the Target FIE is the approval authority in charge of the approval of any capital contribution made by an investor in such Target FIE using an equity interest of an Equity Source Company.
- **Procedure.** To obtain the requisite approval, the contributing investor or the Target FIE will need to submit the approval application in connection with its intended contribution of an equity interest held by it in an Equity Source Company to the Target FIE. If deemed appropriate, the approval authorities of the Target FIE will then grant a conditional approval first to the Target FIE. After the completion of the filing or approval procedures with respect to the equity transfer in relation to the Equity Source Company and the actual injection of the concerned equity interests into the Target FIE, the contributing investor and the Target FIE will then apply to the relevant approval authorities for the final approval and the approval authorities will grant a final FIE approval certificate if appropriate.
- **Time Frame.** The Provisions do not specify the time frame required to complete the entire approval process relating to the contribution of equity interests into a Target FIE. It is noted that, under the SAIC Measures, the contribution of an equity interest for the purpose of establishing a new company is required to be completed within one year from the establishment date of such company, which requirement presumably will apply to FIEs. The approval procedures for contributing equity interests to an existing FIE are generally far more complicated than those for contributing equity interests for establishing a new FIE and may take more than one year to complete, as a practical matter.

Impacts on Ability to Borrow Foreign Debts or to Acquire Duty-Free Equipment

Under the current FIE laws and regulations, an FIE may borrow foreign debts in an amount up to or equal to the difference between its approved total investment amount and its registered capital. An FIE is also entitled to import equipment on a duty-free basis up to the approved total investment in such FIE. Article 18 of the Provisions excludes the contributed equity interests of Equity Source Companies in a Target FIE for the purpose of calculating such Target FIE's total investment amount, thereby limiting the ability of such Target FIE to borrow foreign debt and import duty-free equipment.

Impacts on Onshore M&A Transactions

With the promulgation of the Provisions, MOFCOM effectively permits an onshore merger or acquisition transaction to be structured as an equity swap, thus reducing the cash flow needs of the parties to these transactions and thereby offering more flexibility to investors in structuring their onshore mergers and acquisitions. However, as discussed above, any transaction involving contributions of equity interests of another company to an FIE would be subject to a set of complex approval procedures, which need to be carefully planned and managed to avoid any delay in the approval process.

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