

# For your own protection

## When acquiring state-owned equity interests from their partners, private investors must protect their pre-emptive rights in order to control costs and manage risk

The gradual opening of Chinese industries that were traditionally dominated by the state over the last decade has provided great opportunities for private investors, particularly in the sectors of infrastructure, transportation, and manufacturing. Investors have generally been most interested in forming a joint venture with state-owned enterprises (SOEs) due to the dominant position of these enterprises in the relevant domestic market and their well-established relationship with the governing authorities. Investors hope that both will ensure the long-term development of the joint venture.

SOEs do not always share this idea, however. For political and/or economic reasons the SOE may choose to walk away during the course of the JV or private investors may attempt to buy out their partner. In both cases, the private investor will face a dilemma about how to protect its pre-emptive right during the mandatory listing process of transferring the equity owned by the SOE in the JV. There are several possible solutions available in these circumstances.

### The legal puzzle: pre-emptive rights v protection of state-owned equity

Under the *PRC Company Law*, shareholders of a limited liability company are entitled to pre-emptive rights which provide the current shareholder(s) with first option to purchase the equity held



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by another shareholder upon its decision to sell at the same terms offered by a third party. As long as the equity is held by an SOE (Chinese laws are not clear on whether SOE in this context covers enterprises in which the state holds merely a non-controlling stake), transfer of such equity shall be subject to a statutory listing procedure which is aimed at ensuring that the state-owned equity being transferred is at the highest offer through a public bidding.

Undoubtedly a shareholder's pre-emptive right, which was established to protect the interests of the non-transferring shareholders, clashes with the general legal principle of protecting state-owned equity by maximising the interests of the SOE as a transferring party. The current laws fail to provide any solution about how to avoid such conflict, leaving a loophole for various interpretations. The listing procedures for transferring state-owned equity must be carried out through a qualified equity exchange. In practice, the implementing rules of each equity exchange become

critical in determining how a non-transferring shareholder could exercise its pre-emptive right during a listing procedure.

Until recently, the State-owned Assets Supervision and Administration Commission (Sasac) had not made a significant move to standardise the listing procedures among different equity exchanges. However, Sasac promulgated the *State-owned Equity Exchange Operation Rules* (企业国有产权交易操作规则), which came into effect on July 1 2009. Unfortunately these new rules do not solve the problem of how best to balance the protection of state-owned equity and the pre-emptive rights of shareholders. They merely reiterate the principle that the exercise of pre-emptive rights shall be carried out in accordance with the relevant laws. Without clear guidance on the procedures, a non-transferring shareholder must largely rely on interpretations by different equity exchanges in practice.

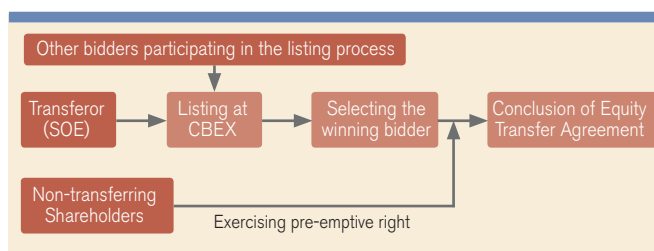
### Rules of equity exchanges: Beijing v Shanghai

Equity exchanges are quasi-government organisations in China and are normally located in large cities. Most equity exchanges have their own procedural rules of listing and when a transfer of state-owned equity is carried out through listing at an equity exchange, the process is essentially led and monitored by the equity exchange.

In practice, equity exchanges have two types of rules which result in two different implementing schemes as to how to exercise a shareholder's pre-emptive right. Internal rules of some equity exchanges (such as the China Beijing Equity Exchange, or CBEX) are substantially more preferable to the non-transferring shareholder. By contrast, rules of other equity exchanges (such as Shanghai United Asset and Equity Exchange, or SUAEE) are more favourable towards the transferring shareholders.

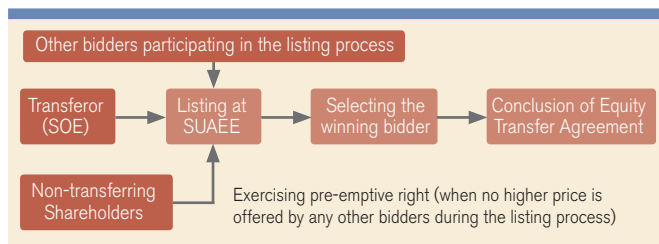
#### (I) The Beijing scheme

According to the *Property Exchange Rules of CBEX*, once the winning bidder is determined through the listing process, the non-transferring shareholder(s) of the target company may exercise its/their pre-emptive right to purchase the equity at the same terms offered by the said winning bidder.



## (II) The Shanghai scheme

The *Shanghai Property Exchange and Bidding Rules* issued by the Shanghai Property Rights Exchange Administration Office provide that the non-transferring shareholder(s) may exercise pre-emptive right by participating in the listing process and offering the same price as that offered by other bidders.



Under the Beijing scheme, the non-transferring shareholder is not required to participate in the listing procedures and may exercise its pre-emptive right when all the terms of the equity transfer agreement are settled between the transferor and the winning bidder. This gives the non-transferring shareholder greater liberty to exercise its pre-emptive right while avoiding competing with other bidders during the listing process. The Shanghai scheme by contrast puts the non-transferring shareholder in a more difficult and vulnerable situation as it is obliged to participate in the listing procedures and compete with other bidders. During the on-site or online competition, each exercise of pre-emptive right actually could easily be denied by other bidders if they offer a higher price under the Shanghai scheme.

### What can be done?

Various strategies may be implemented by private investors in order to best protect their pre-emptive rights in a joint venture with SOEs:

**Specific arrangements in a joint venture contract or shareholders' agreement:** Before the establishment of a joint venture with an SOE, private investors need to explore a feasible scheme to fully protect their pre-emptive rights. In particular, greater effort must be made in formulating the procedural and substantive requirements in the JV contract.

**Seeking possible waiver of listing procedures:** Under PRC laws, transfers of state-owned equity in certain cases are eligible for waiver of the listing procedures as long as an approval is issued by competent Sasac. Private investors may therefore negotiate with the SOE on obtaining such Sasac approval for waiver of the listing if the contemplated transaction can meet the relevant legal criteria.

**Choosing the exchange implementing a Beijing scheme:** Given the important role of an equity exchange in the process of listing, choosing one that implements a Beijing scheme will obviously make it easier and safer for private investors (as non-transferring shareholders) to exercise their pre-emptive rights. Pursuant to Sasac regulations, transfer of equity held by an SOE at central level (or its directly controlled subsidiaries or sub-subsidiaries) may be listed at either CBEX in Beijing, SUAEE in

Shanghai, or exchanges in Tianjin or Chongqing. Although the SOE decides which exchange to use for listing, private investors – as existing shareholders – are normally involved in making this decision in practice.

For transfer of equity held by SOEs at local level, there is little room for choosing an exchange as local government normally requests such transfer be listed at the company's local exchange.

**Negotiating with the equity exchange:** Despite the varied implementing schemes among the different equity exchanges, there are precedents that an exchange may implement and which provide different schemes for different cases in terms of protecting shareholders' pre-emptive rights. Because the internal rules of equity exchanges are essentially neither law nor regulations, it is legally possible and feasible for private investors, as existing shareholders, to negotiate with the equity exchange so as to seek a more favourable scheme for best protecting their pre-emptive rights. A recent case in SUAEE shows the exchange actually adopted a scheme similar to the Beijing scheme for securing the pre-emptive right of an existing shareholder. (See the Shanghai Property Rights Exchange Administration Office website: [http://www.shcgb.com.cn/property\\_right/show.php?itemid=81](http://www.shcgb.com.cn/property_right/show.php?itemid=81)).

When listing, a private investor should avoid:

**Not declaring the reservation of pre-emptive rights:** Normally a specific board or shareholders' resolution approving the listing of the equity to be transferred at a property exchange is required before the contemplated transfer is listed. In case the non-transferring shareholders do not declare the reservation of pre-emptive rights in such resolutions, it may lead to a disputed situation later on as the SOE may claim that the resolution is a tacit declaration of waiving the pre-emptive rights.

**Refusing to participate in the listing or to be involved in the pre-listing process:** Unlike the Beijing scheme, refusing to participate in the listing process is considered as a waiver of pre-emptive rights by many equity exchanges implementing a Shanghai scheme. Choosing not to be involved in the pre-listing process will also make the non-transferring shareholders more vulnerable during listing.

### Conclusion

The global economic crisis has created more concern among private investors in regards to cost control and risk management of their foreign direct investments. As a result, when acquiring the state-owned equity interests from their partners, private investors need to best protect their pre-emptive rights while abiding by basic rules for the protection of state-owned equity. Nevertheless, good strategies can still be implemented to safeguard the pre-emptive rights of private investors who should always try to make a favourable arrangement in the investment agreement in advance and also take an active role during the process of equity transfer.

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