CHINA

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Shareholder loans and Debt-Equity conversions in the PRC

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General principle

Generally speaking, under the current Chinese legal regime, only financial institutions may provide commercial loans. Non-financial shareholders, whether corporate or individual, are not allowed to lend money directly to domestic companies they have invested in. This principle is set forth in the Lending General Provisions of the People's Bank of China.

In reality, shareholders commonly lend money to their companies, and the easiest legal way to do so is to arrange an "entrusted loan". Under this common practice, a shareholder deposits funds in an account at a financial institution that then transfers the money to the company. The terms of the loan are set by the shareholder and the company, and the financial institution usually takes a fee of around 1 to 3 percent.

Exceptions

In some cases, however, shareholders can lend money directly to the company. A Chinese shareholder, for example, can lend money to an overseas company, and a foreign shareholder can lend money to a foreign-invested company (FIE) in China.

The first scenario is covered by the *Provisions on the Foreign Exchange Administration of the Overseas Direct Investment of Domestic Institutions of the State Administration for Foreign Exchange* (SAFE). Before a Chinese shareholder can lend money to an overseas company, it must obtain SAFE approval, which will depend on the asset-liability situation of the lender.

The second scenario is also subject to certain qualifications. Firstly, the FIE's registered capital contributions must have been made by the investors in accordance with the FIE's articles of association (but full contribution of the registered capital is not required). Secondly, the loan must be in foreign currency. Thirdly, upon signing the loan agreement, the FIE must file an "external debt registration" with SAFE. Lastly, if accepting the loan would make the FIE exceed its approved total investment (i.e. registered capital plus foreign debt), the increased total investment requires government approval.

Conversion of foreign debt to equity

Earlier this year the State Council promulgated *Several Opinions on Further Improving Foreign Capital Utilisation* for the purpose of diversifying the utilisation of foreign funds. General implementation guidelines for this legislation were issued by the State Administration for Industry and Commerce (SAIC) through its *Several Opinions on Fully Functioning the Administration for Industry and Commerce to Further Serve the Development of Foreign-Invested Enterprises*. The SAIC opinions encourage FIEs to use foreign debt, such as foreign shareholders' loans, to increase the level of foreign investment by allowing the debt to be converted into equity. Such foreign debt must have been provided in compliance with foreign exchange regulations and must be registered with SAFE. Upon registration with SAFE and approval by the examination and approval authorities in charge of the FIE, the shareholder's loan can be converted into equity for the purpose of increasing the registered capital of the FIE. In other words, the loan may not be used to make a contribution within the existing registered capital amount.

Although there are no detailed rules and regulations at the national level that govern the implementation of debt-equity conversions, a few provinces and municipalities (e.g. Shanghai, Chongqing and Tianjin) have promulgated their own trial methods and have approved such conversions for a few FIEs. Based on the trial methods of Shanghai's Administration of Industry and Commerce (AIC), the capital increase by way of such conversion is subject to the unanimous consent of all shareholders of the FIE and approval by the commerce bureau in charge. The FIE must submit the debt-equity swap agreement signed by the FIE and the respective foreign investor, and must register modifications with SAFE, such as the cancellation of the foreign debt. A verification report must be issued for the capital injection. Lastly, the FIE must carry out alteration registration with the FIE's original registration authority for the increase of the registered capital.

Debt-equity conversion is a new concept for most approval authorities in China. Currently, the process is rather complicated and time consuming, and the introduction of detailed implementation rules by SAFE and other local AICs should make things easier for FIEs and shareholders wishing to take advantage of this option.

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