O'Melveny

Alerts & Publications

China Law & Policy (Summer 2020)—An Insider's Game: Opportunities for Foreign Investors to Engage in Lending Transactions in China

June 30, 2020

KEY CONTACTS

Walker J. Wallace
Shanghai
D: +86-21-2307-7000

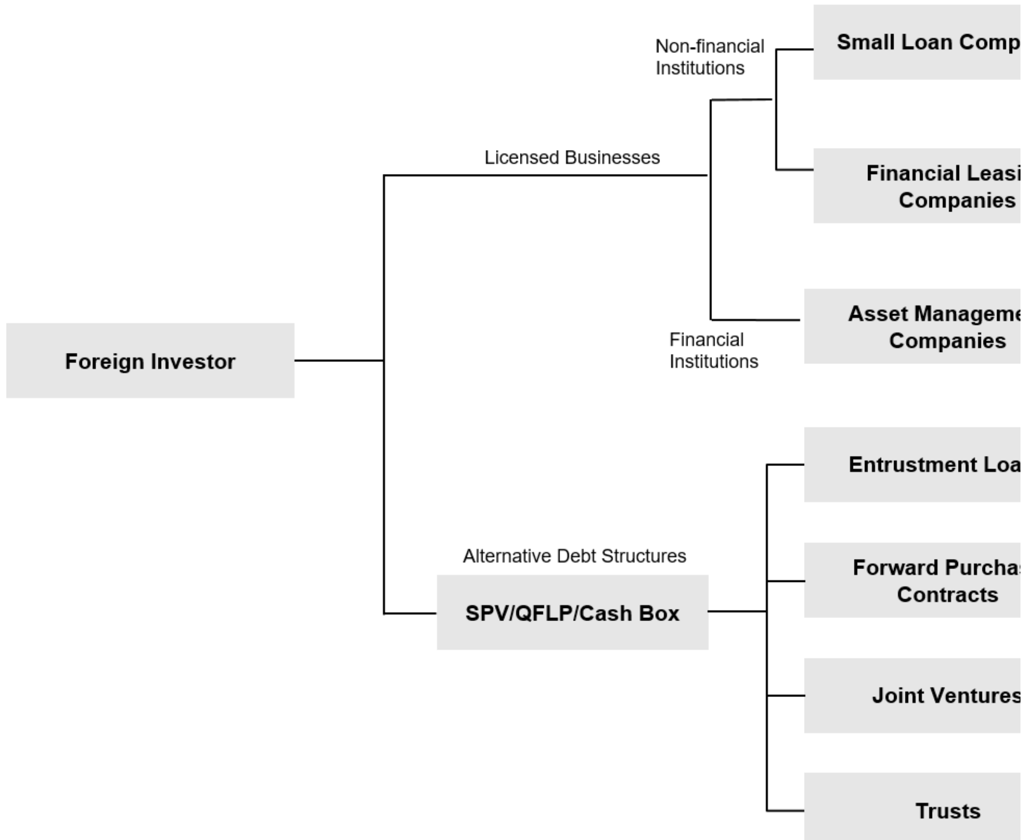
Claire Huang
Shanghai
D: +86-21-2307-7048

Foreign entities generally face regulatory and administrative barriers if they wish to lend money directly to PRC entities. Although fo can legally lend money to PRC domestic borrowers subject to those borrowers' "borrowing quotas," foreign lenders historically have inability to take collateral as a result of legal and administrative barriers. Onshore lending transactions (i.e. between a domestic Chi and a Chinese borrower) are not exposed to the same restrictions on taking collateral, but with few exceptions, only banks and certa financial institutions can secure a license to operate a lending business in China.

New opportunities have developed for non-financial institutions to engage in onshore lending businesses in recent years. Historicall financial institutions engaged in lending activities, any loan contracts they entered into were potentially considered null and invalid u law. Non-financial institutions that engaged in lending activities were also likely subject to sanctions and fines for such activities. Ho Supreme People's Court issued the *Provisions of the Supreme People's Court on Several Issues concerning the Application of Law Private Lending Cases* (《最高人民法院关于审理民间借贷案件适用法律若干问题的规定》) on September 1, 2015, which determine incidental loan agreements entered into by non-financial institutions where the use of proceeds are for production or operating purp and will be recognized by PRC courts. While the validity of a company's lending activity can still be challenged if the lender (not bei institution) regularly carries on a lending business or if lending activities have become its main income source (i.e., the lender effecti an unlicensed financial institution), the Supreme People's Court's stance has effectively opened a door to the use of debt as an inve

Outside of the traditional financial institutions, like banks, PRC law also recognizes certain other institutions as licensed to engage i business, including small loan companies, financial leasing companies, pawn shop companies, and guarantee companies. Among types, small loan companies and financial leasing companies offer interesting opportunities to foreign fund investors. Obtaining bus licenses for pawn shop companies and guarantee companies has been historically relatively difficult for foreign investors. Moreover investor sought to buy a pre-existing pawn shop or guarantee company, it would still need to obtain approval from relevant authoritie restrictions on foreign ownership and would need to expend significant resources to locate and purchase an appropriate target that l legal and business risks built in.

In this article, we analyze the legal and regulatory framework for (i) business entities that are explicitly licensed to carry on a lending China and (ii) alternative debt structures that could facilitate such a business even for business entities that do not qualify as a finan institution. Please see below a diagram summarizing the two routes described above.



I. Licensed Businesses

Set forth below is a brief description of possible entities that could be established or acquired by a foreign investor that have the abil in financing transactions.

A. Small Loan Companies

The legal framework governing small loan companies authorizes certain localities (e.g., Tianjin, Chongqing and Shenzhen) to appro regulate the set-up and operation of these companies. Compared with other regions, Chongqing has adopted the most aggressivel regime for such small loan companies. While the national *Guiding Opinions on the Pilot Operation of Small Loan Companies* (《关 司试点的指导意见》) are silent about caps on foreign ownership for small loan companies, each local jurisdiction has put a different shareholding, with Chongqing being the only one to allow 100% foreign ownership.

Pursuant to the *Interim Measures of Chongqing Municipality for the Administration of Pilot Small Loan Companies* issued in 2008 ar *on Adjusting the Relevant Regulations of Chongqing Small Loan Companies* issued in 2016, small loan companies in Chongqing ar engage in the following business activities: (i) direct lending, (ii) handling the discount of negotiable instruments, (iii) transferring ass industry lending, (v) purchasing financial products issued by licensed financial institutions, and (vi) making equity investments within small loan company's registered capital.

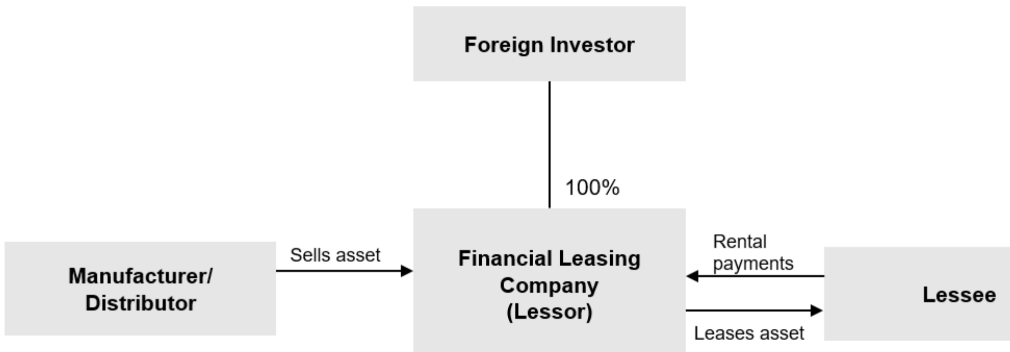
Establishing small loan companies in Chongqing requires prior approval from the Chongqing Finance Office. In 2017, a *Notice on R and Rectifying the "Cash Loan" Business* (《关于规范整顿"现金贷"业务的通知》) was issued to suspend approvals for establishing i loan companies and cross-province business by small loan companies nationwide. Notwithstanding, there may be opportunities for investors to acquire existing small loan companies to the extent that there are reportedly companies that were set up and never utili investors. The restriction on cross-province business has theoretically always applied to small loan companies. Small loan compan Chongqing have historically side-stepped the requirement by requiring borrowers to establish a borrowing vehicle in Chongqing, fror borrower up-streams the loans to a parent company.

B. Financial Leasing Companies[1]

Pursuant to the *Administrative Measures of Supervision on Financial Leasing Enterprises*, financial leasing companies can engage i financial leasing business, which means purchasing a movable property (i.e. not real property) designated on behalf of a lessee and the property to the lessee in consideration for regular rent payments. The leased property must have clear ownership, exist in real li able to generate income. A financial leasing company is not allowed to (i) take deposits or raise money from the public or (ii) engag lending transactions. Notwithstanding the limit on "direct lending," leasing transactions have been structured to work effectively like loans—where rentals mimic amortized loan payments and the ability to seize the leased property mimics a collateral right.

A foreign investor may establish a wholly foreign-owned financial leasing company. However, current local rules governing financial companies are likely in flux due to the change of administrative authority from the Ministry of Commerce (MOFCOM) to the China Ba Insurance Regulatory Commission (CBIRC) in April 2018. The CBIRC further issued the draft *Interim Measures for the Supervision Administration of Financial Leasing Companies* (融资租赁公司监督管理暂行办法（征求意见稿）) on January 8, 2020, which delegat regulation of financial leasing companies to the local finance regulation department at the provincial level. Various provincial finance departments recently issued or are in the process of issuing detailed rules to regulate financial leasing companies at the local level.

Please see below a diagram summarizing the financial leasing company structure.



C. Asset Management Companies

Pursuant to the *Economic and Trade Agreement between the Government of the People's Republic of China and the Government o States of America* (the "Trade Agreement") issued in January 2020, U.S. financial services companies can apply to set up licensed a management companies (AMC) that allow the direct purchase of non-performing loans from Chinese banks, beginning with licenses provincial level. This is interesting in light of how China's existing AMCs conduct business. Originally established largely to buy anc performing loans from Chinese banks, largely on the strength of their cash positions and their expansive business licenses, they hav to expand beyond these beginnings to build lending businesses—largely lending to China's real estate industry.

It is still very unclear how the undertakings in the Trade Agreement will play out in practice. For example, with few exceptions, provi authorities are currently only allowed to establish or permit the set-up of at most two asset management companies. Whether a fore could realistically expect to secure one of these licenses or whether this quota will be revised to make room for foreign-invested AM unknown. Further, it is not clear that the business scope allowed to such an AMC would be nearly as generous as the business sco Chinese AMC.

II. Alternative Debt Structures

Under the legal and regulatory framework for licensed institutions discussed above, foreign investors would need to commit significa to either obtain the required licenses or acquire appropriate target companies that hold such licenses. This Section introduces an al approach where a foreign investor could use an unlicensed domestic investment vehicle, either a company or a limited partnership, lending through alternative debt structures.

Onshore Investment Vehicles

PRC law historically restricted foreign-invested enterprises from using foreign capital contributions to make equity investment or exte narrow exception existed for foreign invested enterprises whose business scope explicitly permitted investment activities, but it was difficult to get such a business scope.

The restriction on reinvestment of capital was lifted by the State Administration of Foreign Exchange (SAFE) in October 2019. This window to interesting investment structures. For example, an SPV could be set up by a foreign fund, which in turn could invest 100' capital into a Chinese company (a "Granddaughter Company") as redeemable equity, with the redemption feature collateralized by a Granddaughter Company or other onshore shareholders. Moreover, to the extent that such investment in the Granddaughter Comp treated as a domestic investment, it would not be subject to the same controls as would normally apply to investment by an offshore into a Chinese company.

In part because a Granddaughter Company structure could be so easily used to side-step PRC capital controls or foreign investmen there is a real question as to how long the window of opportunity for these type of investments will remain open. When SAFE lifted t restrictions on reinvestment of capital, it specified that (i) a Granddaughter Company must not be in an industry that is forbidden to f investment on the Negative List and (ii) investment in the Granddaughter Company must be for a genuine project that complies with laws. The second prong of this is sufficiently ambiguous that it could be leveraged by SAFE to disallow Granddaughter Company in based on changes in government policy over time.

An alternative to relying on the SAFE reforms would be to have an investment vehicle in China that did not depend on this new disp could leverage retained earnings. Two potential structures are the so-called “cash box” structure and qualified limited partnerships (

A “cash box” company is a pre-existing company whose assets largely consist of retained earnings (e.g. a development company fo buildings that has sold all its properties). Because the process of liquidating a foreign-invested enterprise has historically proven ext consuming (requiring one to two years), the owner of such a company might be better off selling the pool of cash. Because the cash “cash box” company are retained earnings, it is not subject to any of the restrictions that would apply to investment of registered cap described above.

A qualified limited partnership has a number of advantages over a “cash box” company. Not least, it can invest money out of its inve and it is subject to a lower rate of overall taxation. Whereas investment returns realized by a “cash box” company would be taxed o prevailing corporate tax rates of 25% and a second time on repatriation at a withholding rate of 5% to 10%, returns earned by a QFL only be taxable at a rate of 25%. A drawback of QFLPs is that they are restricted from certain business activities pursuant to local r

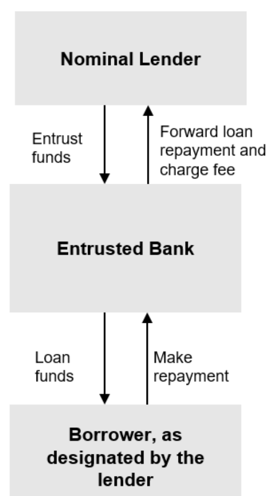
Although neither “cash box” companies nor QFLPs are licensed to engage in the lending business, both can effectively engage in fi transactions by leveraging synthetic debt structures described below, including entrustment loans, forward purchase contracts, joint and trusts.

(a) Entrustment Loans

Entrustment loans refer to inter-company loans facilitated by an intermediary financial institution (typically a bank) that administers t intermediary financial institution acts as an agent of the entrusted funds from the lender and then lends the entrusted funds to a borr designated by the lender. The entrusted bank is responsible for the collection of principal and interest, for which it charges a fee, bu accept any of the loan risk, which remains with the lender.

Entrustment loans have been historically popular, especially before the Supreme People’s Court opened the door to incidental lendi non-financial institutions. However, the CBIRC tightened regulations over entrustment lending in 2018. Now, intermediary financial are required to conduct due diligence in respect of the source of funds of the lender for the entrustment loan. Further, entrustment l be used for the following purposes: (i) investment in industry sectors which are prohibited by the government, (ii) financial investme bonds, futures, derivatives and asset management products, (iii) registered capital, or (iv) equity investments. Moreover, entrustme typically charge a fee on such loans (varying from bank to bank, usually between 10 and 200 basis points per year) and the ability to collateral arrangements has been uncertain where the entrustment bank may not be as eager to enforce the loan as the effective le

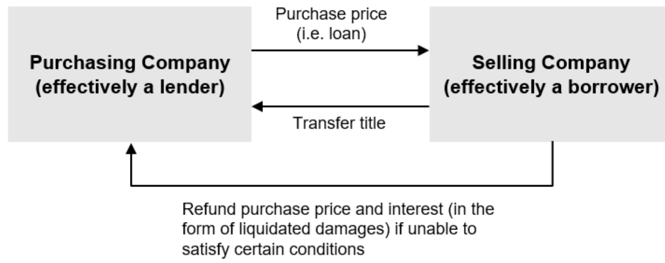
Please see below a diagram summarizing an entrustment loan arrangement.



(b) Forward Purchase Contracts

Forward purchase contracts work by having a “purchasing” company (which is effectively a lender) purchase a key asset from a “se company (which is effectively a borrower). The asset purchased could be a building, shares of stock, or movable property. The “pu company may or may not take title to the asset, but in all cases pays the “purchase price” of the asset to the “selling” company in a after signing the purchase agreement. When the “selling” company is unable to satisfy certain conditions precedent within the time- required under the purchase agreement, the transaction is unwound. The “purchasing” company gives back the asset to the “sellin and the “selling” company refunds the “purchase price” plus liquidated damages equal to an agreed interest rate.

Please see below a diagram summarizing a forward purchase contract arrangement.

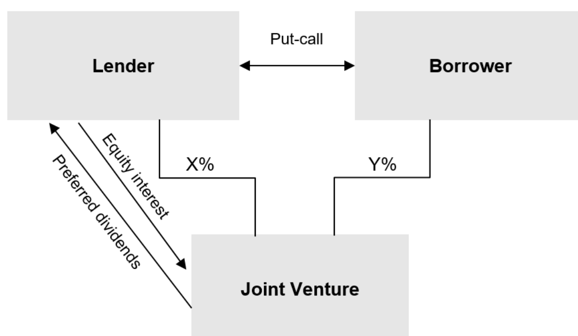


(c) Joint Ventures

Joint ventures can be structured to effectively achieve a financing. Under the terms of the joint venture contract, the lender invests r joint venture as equity. The borrower is typically responsible for continuing operations of the joint venture, although with oversight fr lender. This oversight might involve the lender appointing the legal representative for the joint venture, taking physical possession c company chop and holding signature authority over bank accounts. The joint venture terms typically provide for the lender to receiv return that is equivalent to interest payments under a loan. The joint venture terms also usually provide for a put-call of the lender's interest. To encourage the borrower to comply with the put-call, there is typically an escalator on the dividend rate such that, if the le bought out under the put-call, the dividends payable to the lender step up to a rate that is substantially more expensive than the buy

The advantage of a joint venture is that the structure can be set up at either the onshore or offshore level. That is, either the foreign onshore investment vehicle or the foreign investor itself can be the effective lender, although an onshore investment vehicle has the could require collateral to secure the put-call obligation.

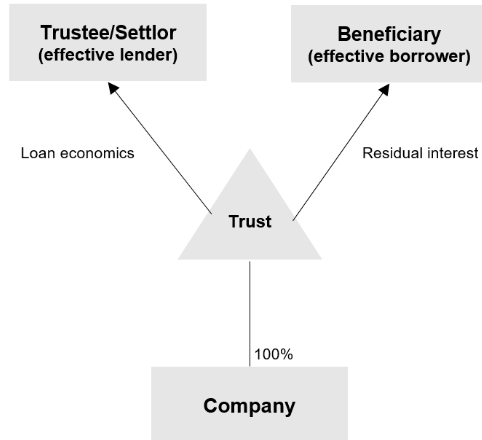
Please see below a diagram summarizing a joint venture structure arrangement.



(d) Trusts

A common financing technique used in the Chinese real estate industry is to deploy trusts to recharacterize the economics from an e investment to model the economics of a debt. For example, a lender sets up and capitalizes a development company. The lender c trust over its 100% equity interest in the real estate company which entitles the lender to receive an amount from any distributions th its principal plus interest. Any residual interest in the trust goes to the developer, who is the effective borrower.

Please see below a diagram summarizing a trust arrangement.



Conclusion

The strategies outlined in this article potentially offer foreign investors more options when structuring investments in China. Not leas suggest ways that foreign investors have been able to engage in collateralized lending, or mimic the economics and legal substance collateralized lending—whether as a stand-alone investment strategy or layered in as a separate tranche in a more complicated inve strategy.

However, while this article highlights some of the structuring opportunities available to foreign investors, it leaves open a number of that would have to be addressed in connection with any investment. Not the least:

- Certain strategies are heavily dependent on establishing a licensed entity within China. Investors will need to consider the pra likelihood of being able to secure such licenses. It has gotten substantially more difficult recently to secure a license for a smal company, while at the same time, China is making moves to open its financial sector more to foreign investment.
- There can be significant value locked up in a licensed entity as a going concern. This has been a major deterrent to many fund setting up small loan companies or financial leasing companies. Not only can the set-up process be time consuming, but realiz of such a vehicle may not lend itself well to the fixed lifespan of a fund investor.
- Each type of arrangement comes with significantly different fund flows and tax implications that may need to be analyzed base of multiple jurisdictions. Tax treatment can require compromises in the structure and vice-versa.
- Many of the structures are novel and, therefore, come with the attendant uncertainties in the event relations sour between lend borrower and the risk of future regulatory changes in China. These risks would need to be balanced in settling on an appropria

As should be clear, properly structuring and executing a debt financing arrangement in China is still complex, with a myriad of legal i risks, even putting aside normal concerns around conducting due diligence on the borrower, transaction timing, and contractual rela However, there may also be substantial opportunities for investors to manage risk and structure financings in a way that maximizes of repayment and improves returns.

---

[1] Under the current PRC legal regime, there are two types of financial leasing companies: one is treated as a financial institution (under strict government supervision and the other is viewed as a non-financial institution (融资租赁公司) under less strict supervisio license required to establish the financial institution type is very difficult to obtain, this article only discusses the non-financial instituti

---

O'Melveny recognizes legal consultant Jenny Wang for her valuable contribution in researching and drafting this article.
