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MANAGING RISKS IN CHINESE M&A TRANSACTIONS

Against the backdrop of China's accession to the WTO and the continuous lifting of restrictions on foreign investment in many industries, China is going through an extraordinary period of merger and acquisition activity. However, executing M&A transactions in China is not for the faint of heart, and making successful investments and striking good deals require more than a gold-rush mentality. In particular, taking an overly cautious approach might result in missing out on great opportunities, while an undisciplined or overly optimistic approach might well lead to disaster. Consequently, it is essential that dealmakers and their counsel take an informed, balanced, and practical approach to the myriad and unique risks presented by Chinese M&A transactions.

Matters that require careful attention in Chinese M&A transactions include regulatory restrictions on commercial enterprise, governmental approvals that are required in connection with purchases and sales of businesses, confirmation of title to assets, assessment of potential liabilities, and structure of purchase price and other amounts potentially payable to the seller. Circumstances in China that tend to make these matters challenging include a legal and regulatory system that is in a state of flux, unavailability and unreliability of public records, unfamiliar customs and practices, a "sellers' market" created by a significant influx of investment capital, and regulatory restrictions applicable to deferred payments of purchase price.

This *Commentary* identifies several key areas of risk associated with M&A transactions in China, with the aim of helping dealmakers identify and address important issues at an early stage.

ASSESSING REGULATORY RESTRICTIONS

An initial matter that a foreign investor needs to assess in setting its expectation is how the Chinese regulatory restrictions and the personal views of the applicable approval authorities may affect the structure and process of the deal. One of the first things that a buyer may want to look into is whether the target company, after being acquired by a foreign investor, can continue to conduct its business and operations in the same manner without becoming subject to additional regulatory restrictions.

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There are still a number of business sectors in China that are not fully open to foreign investors and in which such investors cannot establish wholly foreign-owned enterprises ("WFOEs") or even joint ventures. A foreign investor should determine as early as possible whether there are percentage limitations on potential ownership in an enterprise in a given industrial sector, as this will directly affect the deal structure. For example, if the target company is a conglomerate, some assets may need to be carved out to make sure the postclosing target company will steer clear of the sectors that are "prohibited" or "restricted" for foreign investment.

Through the State Development and Reform Commission and the Ministry of Commerce, China's central government sets the policy and pace of opening up the industrial sectors and publishes and updates the *Foreign Investment Catalogue* every few years. Prospective buyers should immediately familiarize themselves with this guidance. In addition to identifying prohibitions and restrictions on investment in certain sectors, the *Catalogue* lists those sectors where foreign investment is encouraged, which could mean tax holidays and preferential treatment for foreign investors. If the transaction parties can manage to interpret the industrial terms fairly liberally and have the applicable approval authorities agree to such interpretations, the effort may yield significant benefits when the company files its tax returns.

In addition to the restrictions imposed by the central government, attention should be paid to possible regulatory constraints at the local-government level. For instance, the Shanghai government requires licenses for handling public-security projects that cannot be issued to WFOEs.

Although it is reasonable to assume that a share acquisition transaction would allow the target company to keep its licenses and permits after the closing of the deal, the chance of surprises increases when different government agencies are involved in the process. Thus, it is critical to determine at an early stage whether the required licenses and permits can be renewed or exchanged for new ones after the target company converts to a foreign-invested enterprise. As a rule of thumb, the share purchase (or equity interest transfer) agreement would normally time the closing a couple of days after all the necessary approvals, new licenses, and permits have been obtained (assuming that all other closing conditions have been satisfied).

In addition, prospective buyers should not be entirely surprised if due diligence indicates that the target company has been engaging in some of its business activities without proper licenses or permits. In this case, the buyer will need to assess the risk exposure and decide whether it should forgo the transaction, insist that the seller cure the deficiencies prior to closing, or structure the transactions as an asset purchase and apply separately for the required licenses.

NAVIGATING APPROVAL PROCESSES

China's regulatory environment is still rated among the top concerns for U.S. companies, according to a recent survey by the US-China Business Council.[1] Foreign companies investing in China have to deal with the ambiguity of the law and the contradictory views of different government agencies and officials. These conditions frequently result from a combination of ever-changing laws and regulations and formal and informal "implementation rules."

For instance, a government official with approval authority may have his own interpretation of the law and may assure an investor or its counsel that his approach is correct, while officials in another government agency suggested otherwise. Unanticipated "hidden" rules, which can be created by both governmental and quasi-governmental agencies, can also present challenges. For instance, a property registration center[2] may employ local unpublicized procedures that require share purchase agreements or equity transfer agreements to be in a prescribed form.

Avoiding these land mines doesn't take magic, just hard work and vigilance. Foreign investors must do substantial homework to develop keen judgment on legal compliance and risk

1. See *Results of the 2006 USCBC Member Priorities Survey*, August 30, 2006, available at http://www.uschina.org/public/documents/2006/08/member-priorities-survey.pdf.
2. This is a quasi-governmental agency that is responsible for the registration of leases and real-property title, sale, and purchase transactions, as well as monitoring the process of sale or auction of state-owned enterprises.

assessment in China. Foreign investors not familiar with China should resist the urge to make "innocent" assumptions and should engage sophisticated counsel to detect and resolve issues as early in the process as possible.

CONFIRMING TITLE TO ASSETS

In China, the verification of the ownership of assets can present substantial challenges. Publicly available information and government records, if they exist, may be inadequate or unreliable. For private companies, internal documentation is usually not well kept and organized, and it may be insufficient to show what assets belong to whom. For state-owned enterprises, the situation may not be significantly better, and requests for information often meet with reluctance and the "state-owned" culture of secrecy.

It is important to realize that a target company's assets may have been used in related-party transactions. For example, one company's assets might have been pledged for another's bank borrowings, and the same assets might have been used multiple times for making (registered) capital contributions in different companies. The buyer also needs to be extremely careful if substantial assets of a target company were bought from the bankruptcy auction of a state-owned enterprise. If the process was not properly supervised by the court and the case was not effectively closed, the sale could risk being overturned because of a flawed auction process.

Finally, prospective buyers must be vigilant and vigorous in title search and verification. Many state-owned enterprises, and sometimes even privately owned companies, may use or claim to "own" land officially labeled as "allocated land," which is provided by the government at nominal cost (or no cost at all) but cannot be sold, transferred, mortgaged, or otherwise disposed of. A marketable title, or "granted land-use right," must be obtained before such land can be sold or transferred, which could require the payment of significant land premiums to the land bureau.

ASSESSING LIABILITIES

Contingent and off-balance-sheet liabilities may present another serious area of risk for buyers of Chinese companies. Typical areas of potentially significant liability exposure include tax, employment, legacy problems, and environmental issues.

Tax due diligence should be an integral part of any buyer's assessment of a Chinese company. Failure to capture irregular or illegal tax practices and quantify the associated hidden liabilities and downside risks could lead to serious problems. In addition to overstated financial projections and an inflated purchase price, latent problems in this area may result in future tax audits, assessments for past-due taxes, and hefty penalties.

Despite the severe civil penalties and the possibility of criminal prosecution, it is not uncommon to discover tax evasion, aggressive and irregular accounting and tax practices, and even tax fraud in a Chinese company. Some Chinese companies keep two or more sets of books in order to understate tax exposure. Related-party transactions are commonplace and sometimes are based on handshakes and oral arrangements, with the result that the transactions are neither documented nor reflected in the company's books. Through these transactions, profits may be shifted to domestic entities that are in a loss position or to offshore entities such as those in Hong Kong. If it is determined that a transaction has violated PRC transfer-pricing laws, the company may have to pay back taxes and penalties. Buyers should also keep in mind another important aspect of Chinese tax law—there is generally no statute of limitations for tax liabilities. Awareness of this circumstance may be particularly important when allocating tax exposures and entering into related indemnification or other arrangements.

Employment issues frequently arise when the target is a state-owned enterprise with significant labor redundancy. Major layoffs might trigger worker protests and other social unrest, thereby politicizing the transaction and attracting unwanted attention from the local government authorities. Another frequently encountered issue is how much of the workforce the target company may reduce after the acquisition. This is often a heavily negotiated issue, and the seller may even bring it up again at the last minute, hoping the buyer will compromise. Given the political complications of employment matters, it would be prudent for the buyer to take a firm stand about its position, negotiate relentlessly upfront, and resist the temptation to leave this issue behind

for future "friendly discussion." Once the deal is otherwise cut, discussions on cutting back the workforce are likely to be neither pleasant nor friendly.

Finally, one of the most difficult headaches for potential buyers of Chinese companies is the legacy issue inherited from former state-owned enterprises or created during the "reform and restructuring" (*i.e.*, privatization) process. Buyers of privately owned companies that were restructured or converted from former state-owned enterprises should be alert to possible violations and liabilities associated with the prior "restructurings" or management buyouts.

A normal due-diligence investigation frequently will not reveal much in terms of such legacy problems, because any problematic elements of the company's history are likely to be kept secret until a corruption scandal erupts—usually when a local official loses his job or gets investigated. In such cases, it frequently turns out that the seller does not have clean hands. To understand the company and assess the risks, the buyer should fully engage its local teams (including private investigators, if needed) to gather local intelligence and sniff out hidden issues to the greatest extent possible. If the "shadow of doubt" cannot be eliminated, then it may be necessary to consider alternative courses of action.

PURCHASE PRICE AND CLOSING MATTERS

To deal with uncertainties over valuation and mitigate the risks associated with the acquired company, acquirers should carefully craft a purchase agreement with an acceptable payment arrangement (for the purchase price) that is workable under PRC law.

Unlike M&A transactions in the U.S., the options of escrow accounts and holdbacks in China are quite limited and unsatisfactory due to regulatory constraints and an underdeveloped banking-services market. PRC law requires a foreign investor to make payment within three months of the issuance of the new business license of the acquired target. The deadline may be extended, subject to government approval, but no less than 60 percent of the payment must be made within six months of the issuance of the new business license, and the balance must be made within one year. This effectively means that a holdback arrangement, if any, cannot extend for more than a year, which may not be long enough for the buyer to discover contingent or hidden liabilities. As escrow is a fairly new concept to many banks in China, they are reluctant to get involved in situations that may give rise to potential disputes. Although in some exceptional cases banks are willing to accommodate the transaction parties, such accommodations may well involve the assessment of hefty fees. If the transaction can be partially structured offshore and part of the payment can be made to a bank account outside China, holdbacks and escrow for the purchase price may be easier to arrange, as they are no longer subject to Chinese regulatory constraints.

A creative earn-out arrangement can also serve as a mechanism to help the buyer mitigate potential risk exposure arising from contingent liabilities. (It can also be used to bridge differences between a seller and buyer over valuation of the company.) For instance, a buyer could agree to make an additional payment several years after the closing if the venture achieves a specified earning target and there has been no material breach of representations and warranties by the seller.

In addition to careful drafting to minimize the risk of gamesmanship in defining the financial targets and calculations of earn-out payments, special consideration needs to be given to creating a mechanism that is enforceable and practical under PRC law. If an earn-out is treated as part of the purchase consideration, then it will be subject to the same payment deadline applicable to the purchase price, which is within a year following the issuance of the new business license of the target. Consequently, it is necessary to craft the earn-out language artfully to make sure that any additional payment, in the eyes of regulatory authorities, judges, and arbitrators, does not constitute payment of a portion of the purchase price. For instance, a buyer could instead agree to pay a consulting fee to the seller if certain liabilities are not triggered within two years of the closing. However, the seller may be wary of the tax implications of such an arrangement.[3]

3. Depending on how the earn-out payment is treated for tax purposes (*e.g.,* capital gains, salary income, or "other labor income"), different tax rates may apply.

Another option is a buyback arrangement, where the buyer can request that the seller repurchase the equity interests originally sold to the buyer at a fixed price upon the occurrence of specified events, such as the company's failure to meet certain milestones or material breaches of representations and warranties by the seller. But the enforceability of such clauses remains to be tested, and they may be subject to regulatory obstacles. First, such a buyback will be subject to approval again when the change of shareholders needs to be effected, and there is no guarantee that the approval authorities will endorse the repurchase, especially when there is no clear guidance under PRC law on how to deal with such a situation. Second, the PRC Equity Joint Venture Law stipulates that the unanimous approval of the board of directors is required for matters such as mergers and acquisitions and changes to the articles of association. Thus, in the context of a joint venture, if the directors appointed by the "seller" refuse to approve the repurchase, it is an open question whether the foreign investor can enforce such a clause in the PRC courts to obtain board approval.

CONCLUSION

Foreign investors may face many potential pitfalls when doing deals in China. However, with China's robust economy continuing to attract capital, there will be more deals and more competition in a changing legal and regulatory environment. As a result, investors will need to deal with these challenges in an informed, flexible, and practical manner. Winning the game will require a deep understanding of the peculiarities of the Chinese political, regulatory, and business environment, coupled with the ability to adapt to the particular circumstances presented. Experienced, creative, and practical counsel can provide invaluable assistance in enabling investors to make informed decisions that balance the risks and opportunities in the China market.

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