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The Risks Of The Deal – Managing M&A Transactions In China

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As an increasingly powerful cylinder of the world's economy engine, China continues to attract significant influx of foreign capital to fuel its growth spurt and witnesses an extraordinary period of cross-border mergers and acquisitions. In this turbulent yet rapidly evolving market, however, making successful investments and mastering the "art of the deal" require a profound understanding of the unique risks and challenges as well as quick and creative adaptation to the local context. Such unique challenges for foreign acquirors are often associated with one or more of the following "risk factors": a legal and regulatory system that is in a state of flux, restrictions and limitations on deal structures, unfamiliar customs and practices, and difficulty in discovering hidden liabilities and other problems.

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

Navigating Through The Red Tape For Approval

China's regulatory environment is still rated among the top concerns for U.S. companies, according to a recent survey by the U.S.-China Business Council.[1] An initial matter that a foreign investor needs to assess in setting its expectation is how the Chinese regulatory restrictions may affect the structure and process of the deal, in particular, 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. There are still a number of business sectors in China that are not fully open for foreign investors, in which such investors cannot establish wholly foreign-owned enterprises or even joint ventures. A foreign investor should determine as early as possible whether there are percentage limitations on its potential ownership in an enterprise in a given industrial sector, as this will directly affect the deal structure.

Foreign companies investing in China have to deal with the ambiguity of the law and 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." 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 that share purchase agreements or equity transfer agreements be in a prescribed form.

There is no magic to avoid these landmines other than hard work and vigilance. Foreign investors and their counsel should therefore resist the urge to make "innocent" assumptions, and must do substantial homework to develop a keen judgment on legal compliance and risk assessment in China.

Assessing The Assets And Liabilities

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, the internal documentation is usually not well kept and organized, and it may be insufficient to show what assets belong to whom. For the state-owned enterprises, the situation may not be significantly better, and requests for information often meet with reluctance and the "state-owned" attitude of secrecy. 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.

Contingent and off-balance-sheet liabilities may present another serious area of risk for the buyers of Chinese companies. Typical areas for potentially significant liability exposures 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 resulting in 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 prosecutions, 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 exposures. 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 a company's books. Through these transactions, profits may be

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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 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 up front, 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 will likely 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 will likely 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 minimize these risks, the buyer should fully engage its local teams (including private investigators, if needed) to gather local intelligence and sniff out hidden issues as much as possible to understand the company and assess the risks. 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, acquirors should carefully craft a purchase agreement with an acceptable payment arrangement (for the purchase price) that is workable under the PRC law.

Unlike M&A transactions in the U.S., in China the options of escrow accounts and holdbacks are quite limited and unsatisfactory due to regulatory constraints and an underdeveloped banking services market. The PRC law requires a foreign investor to make payment within three months after 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 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 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 the valuation of a 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 the 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 and 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 after the closing. However, the seller may be wary of the tax implications of such an arrangement.[3]

Another option is a buy-back 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 buy-back 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 the PRC law on how to deal with such a situation. Second, the PRC Equity Joint Venture Law stipulates that unanimous approval of the board of directors would be 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 court 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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[1] *See* Results of the 2006 USCBC Member Priorities Survey, *August 30, 2006, available at www.uschina.org/public/documents/2006/08/member-priorities-survey.pdf.*

[2] *A quasi-governmental agency that is responsible for registrations of leases and real property title, sale, and purchase transactions, as well as monitoring the process of sale or auction of state-owned enterprises.*

[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.