MERGERS AND ACQUISITIONS IN CHINA. PART TWO:

Acquisitions in China are still difficult to complete by Western standards, but not impossible.

ANATOMY OF A DEAL IN THE MIDDLE KINGDOM

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Obstacles

The M&A landscape in China is full of obstacles, including those described below.

The laws and regulations are inconsistent and unclear. China's regulatory framework for cross-border mergers and acquisitions (M&A) is a combination of ever-evolving laws, regulations, implementations, and policy decisions made by various ministries and governmental agencies. As most of these rules are published by ministries other than the legislature, it places them in a state of constant flux and leaves room for gov-

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ernmental agencies to create their own interpretations of such rules. The inconsistency between the official and hidden rules as well as conflicting interpretations among different ministries of central and local levels frustrates foreign buyers.

Chinese companies lack transparency and due diligence can be challenging. A lack of well-kept company records, unorthodox accounting and regulatory compliance, absence of well-organized risk disclosure procedures, as well as the inclination of Chinese companies to cover-up problems make it difficult for foreign buyers to carry out due diligence and discover and value the target's potential liabilities.

The governmental examination and approval process is complicated and time-consuming. Foreign buyers should be aware that discretionary approvals of cross-border M&A transactions by Chinese governmental agencies are far more than procedural formalities. They involve an examination of specific deal arrangements as if the government was a party to the transaction. Even if the proposed deal is in an industry that is not heavily regulated, the main approval authority, the Ministry of Commerce (MOFCOM), or its local branches may still restrict a foreign buyer's ability to acquire control of the target if the deal triggers the anti-monopoly review. Building relationships with these government officials is an indispensable part of the approval process, as a good relationship with these influential players will make the approval process easier and allow a foreign buyer to obtain more supportive and constructive information from the "insiders."

Strict foreign currency control. As China exercises centralized administration and control over foreign exchange, all activities relating to the receipts and payments of foreign exchange in China are subject to strict monitoring by the State Administration of Foreign Exchange (SAFE) or its local branches. SAFE monitors such items as the opening of a foreign exchange capital account, the verification of a wire transfer for the purchase price, the conversion of foreign exchange acquisition consideration into RMB, the future remittance of dividends to foreign buyers, and debt financing during the operation of the company.

Key challenges and potential "deal breakers"

In evaluating potential Chinese targets, there are many challenges.

Lack of integrity of the target's management. The previous century of turbulence, civil strife, and domestic persecution in China has led, in part, to a mentality of taking what one can first, putting family second and China third. Foreigners are fair game for abuse. Many managers have been known to employ questionable practices and to personally profit from the company's business. Cutting legal corners is the rule and not the exception. In addition, there are disagreements over management control. Owners are often reluctant to give up control, especially to "waiguoren" or foreigners.

The inability to establish clear title to assets. Tracking the ownership and chain of title to assets is very difficult in China. Similarly, it is almost impossible to discover liens and other encumbrances.

High expectations of value. There is a high expectation of value among Chinese sellers attributable to the booming Chinese stock markets, which have outperformed most other equity markets. Unlike foreign companies, the Chinese do not use price-earnings ratios, return on investment, discounted cash flow, or similar valuation methods in setting the purchase price. Valuation ratios for listed companies on China's stock markets are well above those of foreign counterparts, and public company comparables serve as a critical M&A valuation benchmark. Consequently, the higher relative valuations of Chinese companies are a key challenge to completing transactions.

Unreliability of financial statements, lax regulatory compliance. Chinese companies are famous for keeping multiple sets of books. In addition, the finance and accounting function is weak in China. Similarly, there is often ambiguity with respect to tax payments. These items create significant contingent liabilities.

CHINESE COMPANIES LACK TRANSPARENCY AND DUE DILIGENCE CAN BE CHALLENGING.

As a result, there often tends to be a large gap between what a buyer is willing to pay and a seller is willing to accept.

Ownership of the company itself. Another challenge foreign buyers may encounter is the Chinese practice of holding ownership of the company in the names of other people, usually family members or friends. As a result, there are often verbal agreements as to the ownership of the enterprise. In addition, documents filed with the regulatory authorities may conflict with company records.

As a result of these practices, a foreign buyer must spend a significant amount of time and effort to conduct financial and legal due diligence to sort these issues out before jumping into a deal. The level of due diligence is usually more extensive than when a U.S. company buys another U.S. company.

Complex integration. Effective integration of cross-border acquisitions is essential to achieving anticipated operational improvement, particularly in view of language and cultural barriers. In a recent Economist Intelligence Unit survey, respondents selected integration and due diligence as the top two elements most critical to the success of a cross-border M&A deal. Necessary post-acquisition integration steps should be determined as part of the deal execution process. Acquirors lacking experience operating in China must plan thoroughly for cultural practices and local issues.

A FOREIGN BUYER MUST ALSO TAKE INTO CONSIDERATION THE TAX CONSEQUENCES OF THE POTENTIAL STRUCTURE.

Key legal issues

Among other items, the successful completion of an acquisition in China requires understanding of every aspect of the acquisition process and a well-planned acquisition strategy. This section specifies the key legal issues that foreign buyers should consider.

Structure of the deal. Similar to other jurisdictions, the foreign buyer must determine whether to acquire the assets of the target or its outstanding equity. In order to determine the best structure, one must examine all the relevant factors. The advantage of an asset acquisition is that the foreign buyer is able to choose the liabilities it is willing to take, while leaving other liabilities behind. On the other hand, in an equity acquisition, subject to any indemnification, the foreign buyer has to accept the target as a whole and assume all unknown and contingent liabilities associated with the target. The disadvantage of an asset acquisition lies in the fact that the target's key employees, business contracts, marketing channels, clients, suppliers, distributors, and various permits and licenses required for business operation must be individually transferred. The ability to accomplish this in China is uncertain. In addition to the above-mentioned factors, there are some unique issues foreign buyers must consider when pursuing an acquisition in China:

- Under Chinese law, a foreign buyer pursuing an asset acquisition must either use its existing FIE to complete the deal or establish a new FIE as the acquisition entity. If there is no existing FIE available, prior to the close, the foreign buyer must set up the FIE and obtain the required operation permits and licenses. The procurement of such licenses and permits requires government approval and may take a long time.
- A foreign buyer must also take into consideration the tax consequences of the potential structure. In an equity acquisition, only income tax and stamp tax need be paid by the transaction parties. In an asset acquisition, in addition to income tax and stamp tax, the parties may be subject to business tax, value-added tax, land appreciation tax, deed tax, city maintenance and construction tax, education supplementary tax, and, if any, local education supplementary tax (depending on the city in which the target is located). A buyer would normally be responsible for stamp tax and deed tax, and the seller would pay the other taxes. However, this is an issue subject to significant negotiation. These additional taxes may change the economics of the transaction, and the tax impact of both structures must be carefully examined.

Use of an acquisition entity. In most acquisitions in China, the buyer will use an acquisition entity. There are significant tax considerations involved in the selection of the acquisition entity. If a foreign buyer's resident country does not have a preferential tax treaty with China, many foreign buyers tend to use an intermediate holding corporation as the acquisition entity. By using such an intermediate holding corporation, a foreign buyer can enjoy some preferential tax treatment, such as no/reduced capital gains tax and no/reduced withholding tax on dividends, royalties, and interest payments. When choosing the location of the intermediate holding corporation, in addition to the withholding tax rates between the country/region and mainland China, a foreign buyer should consider the following: time and fees for establishing an intermediate holding corporation; cost for maintaining the basic operation of an intermediate holding corporation; the travelling and accommodation fees; and the economic and political stability of the country/region where an intermediate holding corporation is located.

MANY FOREIGN BUYERS CHOOSE TO SET UP AN INTERMEDIATE HOLDING CORPORATION IN HONG KONG.

Based upon these considerations, many foreign buyers choose to set up an intermediate holding corporation in Hong Kong. However, on October 27, 2009, the State Administration of Taxation (SAT) issued "Notice of the State Administration of Taxation on How to Understand and Determine the Beneficial Owners in Tax Agreements" (Notice 601), which requires that intermediate holding corporations must engage in "*substantial business operations*" to enjoy the preferential tax treatment under a bilateral tax agreement between China and such jurisdiction, it further indicates that any "conduit corporation" is not the "beneficial owner" under Notice 601.

The intermediate holding corporation is probably deemed as a "conduit corporation," according to the Notice 601, if:

- the intermediate holding corporation is obliged to pay or distribute to residents of a third country/region the total or most of the income (i.e., 60 percent or more) within the prescribed time limit (e.g., within 12 months after the income is received);
- except for holding properties or rights generated from the incomes, the intermediate holding corporation does not have or hardly carries out other business operations;
- the intermediate holding corporation is a business entity, holds few assets, operates on a very small scale, or hires a very small number of employees which do not match its of income;
- as to the income or the properties or rights generated from the said income, the intermediate holding corporation does not have, or hardly has, the right to control or dispose, and it does not bear any risk or bears very little risk;
- the contracting country/region where the intermediate holding corporation is located does not impose any tax on, or exempts the relevant income from tax, or the actual tax rate is extremely low;
- there is another loan or deposit contract between the creditor and the third party, of which the amount, interest rate, or execution time are nearly the same as those of the loan contract from which the interest is generated and under which the interest is paid; and
- there is another contract between the intermediate holding corporation and the third party regarding the right to use or own a copyright, patent, or technology, apart from the contract on the transfer of the right to use or own a copyright, patent, or technology, from which the royalty is generated and under which the said royalty is paid.

Therefore, foreign buyers are advised to carefully structure the deal to fit in the "beneficial owner" category to enjoy preferential tax treatment.

Structure of the purchase price. Foreign buyers can use cash and equity to acquire a Chinese target. If the foreign buyer uses equity as the consideration in the proposed transaction, the equity used as the purchase consideration must be approved by MOFCOM. In addition, any equity used as consideration must be freely-traded on an overseas securities market and meet other stringent requirements under Chinese law. If a foreign buyer employs an earn-out mechanism where part of the purchase price is paid over time when the target meets certain financial performance benchmarks, the approval of MOFCOM is also required. Moreover, no matter which method foreign buyers employ to pay purchase price, the acquisition consideration must be fully paid within three months from the date of issuance of the business license for the post-acquisition company unless MOFCOM approves an extension of such period to one year. This requirement essentially eliminates the use of an earn-out.

UNDER THE LABOR CONTRACT LAW IN CHINA, A NON-COMPETITION PROVISION IN AN EMPLOYMENT AGREEMENT IS ENFORCEABLE.

Indemnification and holdback of part of the purchase price. In the U.S., it is common for foreign buyers to use holdbacks to mitigate potential risk exposure arising from contingent liabilities, breaches of representations, and warranties and third party claims. However, the enforceability of such payment arrangement in China remains uncertain, and these provisions are subject to regulatory obstacles. Under Chinese law, foreign buyers are required to fully pay the consideration within three months from the date of issuance of business license of the post-acquisition firm. The three-month payment period may be extended to one year if foreign buyers pay no less than 60 percent of the purchase price within six months from the date of the issuance of business license and such payment arrangement receives the approval from the required Chinese government agencies. These regulatory requirements reduce the effectiveness of holdbacks in China, as the one-year period may not be long enough for foreign buyers to discover hidden risks or contingent liabilities.

Appraisal. Unlike the United States where the parties to an acquisition have power to set the purchase price, the value of the target's equity or assets shall be set by an appraisal firm located in China, and such appraisal shall serve as the reference for the parties to set their purchase price. If the government authorities believe that the purchase price is below the appraisal value, the transaction will not be approved.

Non-competition. A non-competition agreement is important for foreign buyers to achieve their acquisition business objectives and protect foreign buyers from competition by former owners or management of the target. No foreign buyer wants the former management that was just paid a large purchase price and is familiar with the products, market channels and other key elements of the business to set up a competing company. Under the Labor Contract Law in China, a non-competition provision in an employment agreement is enforceable. However, only certain employees, such as senior management, senior technical personnel, and those under confidentiality obligations are subject to competition restrictions. In order for a non-competition agreement to be enforceable, the following two conditions must be met: (a) the term of non-competition obligations must not exceed two years; and (b) from the date of termination of the employment contract, the employer shall pay the former employee his or her compensation until the end of the restriction period. Although the Labor Contract Law is silent about the amount of compensation, certain local regulations specify the minimum compensation amount. For example, in Shenzhen and Zhuhai, the compensation amount shall be no less than 50 percent of the employee's last annual income. However in Jiangsu province, the minimum compensation amount shall be at least one-third of the employee's previous annual income. Therefore, foreign buyers must check the local regulations regarding the appropriate amount of compensation.

Representations and warranties. Foreign buyers utilize representations and warranties as a means of better understanding the target and allocating risk among the parties. The suggested representations to be made by Chinese target include, among others:

- the legality of the target;
- the authenticity and accuracy of the target's incorporation documents, its business license, and other relevant permits and authorizations;
- compliance with material laws and regulations, including the anti-bribery laws;
- the legal right to transfer the equity/assets;
- attainment of all necessary government or other entity's approvals to complete the deal;
- the accuracy of the target's financial statements;
- compliance with all material environmental laws and regulations;
- accuracy of the target's employees; and
- the target's tax payments.

Governing law and dispute resolution. In accordance with Chinese law, cross-border acquisitions may only be governed by Chinese laws and regulations. However, since foreign court judgments are not directly enforceable in China and the Chinese courts are inconsistent, foreign buyers usually prefer to use arbitration as a means of resolving disputes. Under the New York Convention, of which China is a member, foreign arbitration awards are enforceable in China. Moreover, foreign buyers are advised to select an arbitration forum outside of China, as over the years arbitration forums in China have been very unreliable. When selecting the arbitration forum, the parties tend to select one located in a neutral country/region to ensure the impartiality. The most frequently selected arbitration institutions are Hong Kong International Arbitration Centre and Singapore International Arbitration Centre. There are several factors for foreign buyers' consideration when selecting the arbitration institution:

- the arbitration application fees and commissions required to be paid to the arbitrators;
- the available arbitrators' knowledge of U.S. laws and Chinese laws and their language skills;
- the reputation of the arbitration institution; and
- the reputations of available law firms that have offices in the country/region.

OVER THE YEARS ARBITRATION FORUMS IN CHINA HAVE BEEN VERY UNRELIABLE.

Chinese government approvals

Acquisitions in China are subject to the review and approval of numerous governmental agencies, below is a discussion of the typical approvals required.

National security review. On February 3, 2011, the General Office of the State Council released the "Notice of the General Office of the State Council on Establishing the Security Review Mechanism for Merger with and Acquisition of Domestic Enterprise by Foreign Investors, (the Notice), which establishes the first detailed review mechanism concerning national security issues. This notice will be effective on March 5, 2011. Under the Notice, the following transactions will be subject to national security review:

- the targets are involved in the national defense industry;
- the targets whose location is adjacent to military installations;
- the business of the targets are more related to national security concerns; or
- the targets are enterprises involved in important agricultural products, energy and natural resources, infrastructure facilities, transportation services, key technologies, or manufacturing of major equipment.

  There is no minimum threshold amount that will trigger national security review but any transaction in the above-mentioned categories are subject to review, provided the proposed transaction will allow foreign buyers to obtain the "actual control" of the target. Actual control means the foreign buyer either has a majority shareholding in the target or can control fundamental business operations or decision-making powers of the targets. Although acquisitions in the above-mentioned categories are subject to national security review, according to the informal guidance posted by

National Development and Reform Commission (NDRC), foreign buyers do not need to make a separate application to initiate such review, rather the MOFCOM may ask the parties to provide information necessary for the security review.

MOFCOM Anti-Monopoly Bureau (AMB). Generally, foreign buyers involved in a merger or an acquisition of a Chinese target must file a pre-transaction application with AMB for anti-monopoly review if:

- the worldwide revenue of all the parties to the proposed transaction exceeds 10 billion RMB in the last fiscal year, and the revenue in China of at least two parties among the proposed transaction participants exceeds 400 million RMB separately in the previous fiscal year; or
- the revenue in China of all the parties to the proposed transaction exceeds 2 billion RMB in the last fiscal year, and the revenue in China of at least two parties among the proposed transaction participants exceeds 400 million RMB separately in the previous fiscal year.

The AMB's mandate is to determine whether the proposed transaction has or may have the effect of eliminating or restricting market competition in China. Therefore, when reviewing the deal, the AMB, subject to the rules of Anti-Monopoly Law, will consider the following factors:

- the market share in the relevant market of the practice and their power over that market;
- the degree of market concentration in the relevant market;
- the impact that the transaction may pose on market access and technological advancements;
- the impact that the transaction may have on the consumers and other business entities;
- the impact that the transaction may put on the national economic development; and
- other factors AMB believes may affect competition in the market.

National Development and Reform Commission (NDRC). Once the national security review is passed, and if the current or future business of the post-acquisition company is involved in or will become involved in manufacturing, equipment import and export, land use, purchase of real property, or establishing or acquisition of overseas non-financial enterprises, the parties shall file the application with NDRC or its local branch for its approval.

Ministry of Commerce (MOFCOM). Depending on the deal size, the parties shall apply with appropriate authorities. If the total deal amount is over $300 million, the approval authority is the central office of MOFCOM in Beijing. For transactions below $300 million, the approval is delegated to provincial or local branches of MOFCOM.

State Administration of Industry and Commerce (SAIC). After receipt of the approvals from the above-mentioned government agencies, the parties shall register with SAIC or its local branches, which will issue the business license to the post-acquisition company.

Other government agencies involving in post-transaction registration. The post-acquisition entity must apply to the local public security bureau to obtain a company seal, apply for an organization code certificate from the appropriate code administration agency, apply to the relevant tax authorities to obtain state and local taxation registration certificates, apply to the appropriate statistics bureau for a statistics registration certificate, and apply to the relevant foreign exchange administrative office for a foreign exchange registration ID card.

In addition, if the target belongs to a specific industry or the target is a state-owned company, the proposed acquisition may require additional approvals from other government agencies which are in charge of such industries, such as the Ministry of Health or State-Owned Assets Supervision and Administration Commission.

Post-acquisition integration plan

A seamless integration following an acquisition is critical to create a unified company and to achieve the contemplated benefits of the transaction. Integrating companies with different cultures

INTEGRATING COMPANIES WITH DIFFERENT CULTURES AND HISTORIES IS A THORNY CHALLENGE.

and histories is a thorny challenge, even when they are close neighbors. The difficulties are amplified when the parties are from different countries and cultures. Integration is usually needed in the following areas: products, employees, information technology, accounting systems, customer service, procurement, distribution, and certain other functions. A foreign buyer should prepare an integration plan early in the transaction and pay close attention to those challenges at every step of the transaction. Several principles are helpful here.

- Assess the degree to which business and cultural integration are needed, across all organization functions, to balance the focus on cost synergies with the growth of the newly combined company.
- Build a formal management team with an emphasis on familiarity with the culture and effective communication to develop and execute the integration plan.
- Seek a complete understanding of the target company's key assets, customers, and major contracts, and take immediate steps to protect the value of the deal.
- Create a plan to retain key employees early in the transaction to actively manage engagement of such employees and changes.
- Integrate the two companies quickly to ensure the effective transition of daily operations.

Avoid common mistakes

Many post-acquisition problems can be traced back to several common mistakes that could have been avoided. Such common mistakes include:

- the failure to define a clear objective and acquisition criteria;
- the failure to conduct broad and thorough business and legal due diligence or research on the target;
- the failure to fully understand the cultural differences and application of solely western-standard business practices in China;
- the over-reliance on personal relationships;
- blindly following "common" local business practices without understanding their legal basis;
- the failure to recognize inconsistent regulatory interpretations and regimes between local, provincial, and central governments and their officials;
- the failure to uncover improper related-party transactions and payments; and
- the failure to understand the limitations on transferring critical licenses. These mistakes continually frustrate foreign buyers in China. Committing these mistakes leaves the foreign buyer vulnerable to the seller and government officials who are content to take advantage of "foreigners." Moreover, these mistakes will consume a tremendous amount of the foreign buyer's time, energy, and money to correct, which could be better spent on productive activities necessary for success in China's competitive and fast-moving environment. By utilizing a well-conceived acquisition strategy and following the roadmap described in this article, these common mistakes can be avoided.

Conclusion

Although acquisitions in China are still difficult to complete by Western standards, M&A activity in China has been increasing and is likely to continue to increase further. With the Chinese government's effort and priority to create a friendlier investment environment, the robust economic growth in China, the increased desirability of China as a market for high-end goods and services, and the increase in experience by foreign buyers in making acquisitions in China, M&A activity can be expected to further accelerate, and its level of complexity will further increase. ■