



MERGERS AND ACQUISITIONS IN CHINA. PART I:

Successful foreign buyers in China are those who appreciate cultural differences and use best-practice strategies to minimize the inherent risks.

ANATOMY OF A DEAL IN THE MIDDLE KINGDOM

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Following a slight decline in 2009, 2010 was a very strong year for mergers and acquisitions in the Middle Kingdom. Statistics provided by Thomson Reuters show that over 3,000 corporate mergers and acquisitions (M&A) involving Chinese companies with a combined deal value of U.S. \$131.1 billion were reported in 2010. Among these deals,

cross-border transactions amounted to U.S. \$80.7 billion, a 21.2 percent increase compared with the U.S. \$63.6 billion recorded in 2009. In terms of the number of M&A deals where the target, acquirer, or ultimate parent are located in China, the materials sector saw the most activity in M&A transactions, accounting for 24 percent of the total, followed by the energy and power sector,

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making up 20 percent. The financial sector came in third place with 17 percent of all the deals. These deals were driven by a number of factors, including the continued economic growth in China, reorganization of state-owned enterprises, acceleration of the pace of Chinese government's "zou chu guo men" or "going out" policy, and desire of foreign companies to enter into new markets by seeking acquisitions in China.

Notwithstanding the increase in M&A activities and a continuously growing Chinese economy, China remains a very challenging environment for foreign buyers. Cultural, regulatory, and legal obstacles make acquisitions in China risky and difficult. Foreign buyers seeking acquisitions in China are usually aware of well-known risks such as questionable business practices, environmental exposure, and lack of intellectual property protection. Unfortunately, they are often unprepared or underprepared to handle a wide range of cultural, legal, and organizational differences present in China. Successful foreign buyers in China are those that appreciate such differences, commit the required resources and efforts to solve such difference, and use best-practice strategies to minimize the inherent risks.

This article identifies the current trends in mergers and acquisitions in China, describes different types of acquisition targets, depicts the roadmap for completing a deal, and discusses regulatory approvals involved in the deal-making process. This article also highlights key obstacles, challenges, legal issues, post-acquisition integration, and common mistakes that are made in connection with acquisitions in the Middle Kingdom and suggests practical strategies to overcome such obstacles and avoid such mistakes.

M&A trends in China

Given the large and dynamic nature of China's market, M&A activities are influenced by many factors, one unique factor of which is that M&A activities in China are closely aligned with the Chinese government's policy priorities. In 2010, the Chinese government continued its effort in restructuring its economy and

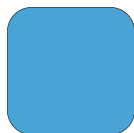
industries through the promulgation of a series of new regulations, aiming to create a friendlier regulatory environment for M&A activities inside China, strengthen environmental protection, restructure state-owned enterprises to encourage them to grow into global companies, and promote the development and growth of high-tech companies. To implement these policy objectives, the following trends are expected in 2011 and the coming years.

Hot sectors for M&A. In the past, tight regulatory policies often favored Chinese domestic companies and restricted foreign investments in many areas. More recent government initiatives have reduced such restrictions and further encourage foreign investments. On April 6th, 2010, the Chinese State Council issued a notice with regard to improving the use of foreign investment. The notice encourages foreign investors to participate in the re-organization and restructuring of domestic enterprises through equity investments and mergers and acquisitions. According to the notice, the Chinese government is expected to amend the Catalogue for Guidance of Foreign-Invested Industries (the "Catalogue") to expand the scope of the encouraged category to promote foreign investments in high-end manufacturing, high-tech, new energy, energy-efficiency, and environmental protection sectors. The amendment has been published by MOFCOM for public comment. Consequently, we expect that these sectors will be hot areas for M&A activity in 2011 and beyond.

Sale of obsolete production capacity. The recently published "Notice of the State Council on Further Strengthening the Elimination of Backward Production Capacities" has set ambitious environmental targets and requires certain energy-consuming sectors such as coal, coke, ferroalloy, iron and steel, buildings, lighting, and transportation industries to phase out enterprises with obsolete production capacity by the end of 2012. To achieve these objectives by the prescribed timeline, the Chinese governmental authorities have incentives to encourage the sale or restructuring of



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HIGH-TECH COMPANIES MAY ENJOY 15 PERCENT PREFERENTIAL TAX TREATMENT.

such enterprises with obsolete production capacity. As a result, in the following three years, we expect to see a high volume of M&A deals in these industries in China.

Restructuring of the state-owned enterprises. In accordance with the opinion of State-Owned Assets Supervision and Administration Council (“SASAC”), the number of state-owned enterprises (“SOEs”) needs to be reduced to 100 by the end of 2010 and further reduced to 80 by 2020. At the end of 2010, the number of state-owned enterprises was still over 120, falling short of meeting the objectives of SASAC. These SOEs commonly are complex organizations with many business units at multiple levels. The reorganization or spinoff of these SOEs will lead to a surge of M&A activities in the coming years.

High-tech company development. The Chinese government has published a number of laws and regulations encouraging the formation and growth of high-tech companies. High-tech companies may enjoy 15 percent preferential tax treatment in addition to favorable funding and employee recruiting incentives. Large high-tech companies tend to prompt and boost the emergence and growth of smaller, local high-tech companies. Local Chinese high-tech companies typically tend to develop their own niche with products or technologies, which often fill gaps in the product/technology lines of multinationals and other large companies. As more and more multinational or large companies source their products/technologies in China, we expect to see these smaller high-tech companies become attractive acquisition targets by larger companies seeking to enter China or increase their market share in China.

Wider range of exit strategies. Avenues for exiting investments in Chinese companies have opened as the Chinese government has loosened regulations for foreign investors. M&A transactions by financial and strategic investors have gained acceptance by the Chinese government, both on domestic and cross-border bases. Foreign private equity firms represent a new source of demand for M&A targets. Lately, China has been

more welcoming of foreign private equity funds because of the related job creation in China. As a result, financial investors are likely to find an easier path to approval for public listings of their China-based portfolio companies in China’s stock markets. If the government relaxes its rules regarding foreign companies’ directly listing in China (as is expected in 2011), newly listed firms could raise and use domestic capital for M&A, enhancing exit options.

Greater interest from foreign private equity. Positive changes in government regulations are poised to further increase the interest in China among foreign private equity firms. Rules have been modified to increase the number of RMB-denominated equity investment entities set up by foreign investors, which allow foreign investors to raise funds from Chinese individuals, pension plans, and domestic enterprises. New rules have reduced the tax rate and offered incentives to investors that form RMB-based funds.

Types of acquisition targets

As in the U.S., an acquisition in China may take the form of an asset purchase or a stock purchase, and the acquirer may acquire a controlling majority share or just a minority share. However, unlike the U.S., the target companies in China have an array of forms with distinct characteristics. Typically, these targets can be divided into the following four categories.

Acquisition of a State Owned Enterprise. SOEs are the Chinese companies owned by the Chinese government and are not privately held by Chinese citizens. The rules governing the acquisition of an SOE are different from those governing the acquisition of privately held companies. Foreign buyers must endure a lengthy and complicated approval process to acquire an SOE, as there are various government agencies that oversee the sale of state-owned assets. Under Chinese law, once an SOE receives an offer to purchase, the SOE must go through a public auction process. As a result, the acquisition of an SOE by a foreign buyer is very costly and unpredictable.

Acquisition of a privately held company. Privately held companies are established and owned by Chinese citizens, with no government or foreign ownership. Foreign buyers may purchase the equity interests or assets of a privately held company from its existing Chinese shareholders or the company itself. The acquisition of equity interests of a privately held Chinese company must comply with the limitations on foreign investment percentage in different industries outlined by the Catalogue. In addition to obtaining the approval from the Ministry of Commerce (“MOFCOM”) for such an acquisition, approvals from other governmental agencies will also need to be obtained if the target is in a classified category or in a heavily regulated industry. An equity purchase may convert a privately held company into a foreign invested enterprise described below.

Acquisition of a Foreign Invested Enterprise (“FIE”). FIEs refer to the legal entities set up jointly by the Chinese companies and foreign companies or to the wholly owned subsidiaries of foreign companies set up in China. FIEs all have foreign ownership, ranging from 25 percent to 100 percent. Acquisition of an existing FIE requires the approval of the government agency that originally approved for establishment of the FIE. Restructuring of an FIE or the increase of its registered capital is subject to the limitations provided in Catalogue and may trigger the examination by government agencies at a higher level.

Acquisition of a public company. The acquisition of a company listed on a Chinese stock exchange requires additional government approvals and reviews. In addition to the approval from MOFCOM, the acquisition of a listed company may be subject to the examination of China Securities Regulatory Commission (the “CSRC”) under certain circumstances. Compared with the acquisition of a privately held company, the Chinese government requires a foreign buyer of a listed company to meet more rigid requirements. For example, the total asset value owned or managed by the foreign buyer outside of China must not be less than \$100 million or \$500

million respectively, which will screen out small or mid-sized foreign buyers.

Roadmap for completing a deal

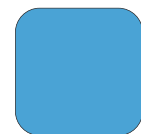
Acquisition of a Chinese company is a long, multi-step process. It often takes a minimum of six months and up to 18 months to close the acquisition of a Chinese company. To complete a successful acquisition in China, foreign buyers are advised to take the following critical steps.

Selection of target. Substantial research for potential targets must be conducted. In addition to the information available on the Internet, there are companies that can conduct thorough research and investigations into Chinese companies. Since Chinese government plays an important role in cross-border transactions, the foreign buyer, before entering into any deal, is advised to conduct research with regard to:

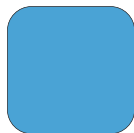
- a. The government’s policies toward the industry in which the target is operating, which will determine whether the post-acquisition company will be able to enjoy or continue to enjoy any preferential tax treatment;
- b. The local investment environment where the target is located;
- c. The experience of the local government officials in dealing with foreign investments;
- d. The nature of the market for talented employees, as many of the most talented people tend to look for jobs in large cities, such as Beijing, Shanghai, and Shenzhen;
- e. Information on the number and background of the target’s competitors; and
- f. The market share of the target and the popularity of its brand, which may trigger the anti-monopoly review of the proposed transaction by the Anti-Monopoly Bureau under MOFCOM.

The data obtained from the foregoing research will help screen the targets and provide a baseline for comparison.

Relationship building. From the initial contact, foreign buyers should work to establish a friendly relationship with the selected Chinese target. Foreign buyers



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are encouraged to not only do business with Chinese partners from a pure money-making perspective but also work on “jiao pengyou” or making true friends. This process goes beyond being friendly and respectful on a superficial level. A good relationship with the Chinese target is important to:

- a. Obtain the Chinese target’s support and cooperation during and after the transaction; and
- b. Improve the negotiation position of the foreign buyer. In China, “mian zi” or “face” is very important, and the Chinese feel embarrassed in taking advantage of a true friend.

Finally, a good relationship helps a foreign buyer win the Chinese target’s trust (to the extent possible), which makes business in China much easier.

Preliminary due diligence. Once the buyer has conducted some initial research and established some type of relationship with the Chinese target, the foreign buyer should conduct some preliminary due diligence regarding the target’s value and market positions by requesting and analyzing information from the Chinese target and comparing such information with the buyer’s own independent research.

Letter of intent. To the extent that the buyer desires to proceed, the next step is preparing a letter of intent. In Chinese deals, the letter of intent should be more detailed than in U.S. deals. A detailed letter of intent tends to give foreign buyers more bargaining power during the later negotiations, reduces “back tracking,” for which the Chinese are famous, and increases certainty of a deal going forward.

Complete due diligence. Once a letter of intent is signed, the foreign buyer should engage a reputable accounting firm and law firm to conduct thorough financial and legal due diligence investigations of the target. A thorough due diligence includes but is not limited to the following (which is not intended to be an exhaustive list).

Assessing financial statements and audits. It is common that many Chinese companies keep two sets of financial records—one for themselves and one for the tax authorities. This practice makes the determi-

nation of the true value of a target more difficult. Therefore a foreign buyer must dig deeper into the financial records to assess the value of a target. This must be combined with an assessment of the target’s goodwill, market share, sales channels, product/service competitiveness, connections, management profile, and key employees. Nothing can be taken at face value and everything must be verified.

Taxes and filings. It is not a surprise that some Chinese companies employ aggressive tax practices and even tax fraud, including understating profits, overstating costs and losses, keeping two sets of accounting books, and illegally transferring profits through related-party transactions. These latent tax evasion acts may result in severe penalties and even criminal prosecutions. Therefore foreign buyers must conduct thorough tax due diligence to discover any hidden tax liabilities and risks.

Human resources. As assimilation of the employees of the target is a key factor to the success of the transaction, foreign buyers should attach more importance to the HR due diligence in China than other geographies. Items such as the compatibility of corporate culture, HR compliance, profiles of the management, backgrounds of technical personnel, compensation, benefits, retirement and benefit plans, department structure, and employment manuals of the target should be reviewed and evaluated. When a foreign buyer intends to acquire a Chinese target, special consideration should be given to layoffs, especially if the target is a SOE. Although many SOEs are well known for their labor redundancy, major layoffs of SOE employees are a politically sensitive topic that will attract extensive attention from the public and will be subject to close and strict supervision from local labor authorities. Therefore, foreign buyers must be well prepared for tackling employment issues and are advised to conduct constructive negotiations with local labor authorities to get their formal or informal opinions regarding the reduction of workforce before sending the deal for approval.

Legal due diligence. In conducting legal due diligence, a foreign buyer should examine, among other things, the following areas.

Establishment.

Foreign buyers must make sure the target was duly incorporated and legally exists under Chinese laws and regulations. Foreign buyers should carefully check the target's business license, tax registration certificate, organization code certificate, and other certificates that are required to conduct the target's business in China. It is common for there to be many problems in this area. In addition, the buyer should obtain and review the "Capital Verification Report," which is used by third party Chinese CPA firms for cross-checking bank statements and confirming the registered capital was paid. It is these simple checks that can separate a successful transaction from a bust.

Organizational structure.

Organizational structure reflects the target's corporate culture, internal hierarchy, management, operation emphasis, and even business development strategy. By examining the target's organizational structure, foreign buyers can assess whether the target organizationally fits in the foreign buyer's strategic development and whether, through the integration of the two companies, the foreign buyer can realize its goal in the transaction.

Ownership.

No matter whether the target is a privately held company or an SOE, the verification of the ownership of assets is a big headache for foreign buyers, as publicly available information and government records do not adequately reflect the ownership of an enterprise. Fortunately, if foreign buyers find no outstanding mortgages and pledges on the target's assets after conducting thorough due diligence, foreign buyers are protected under bona fide third party principle (similar to bona fide purchaser in the U.S.) and take good title to the property despite the competing claims of the other parties. A related issue is the nature of the target's ownership of land. Ownership to land may be "allocated land" or "granted land". "Allocated land" which

is provided by the government at a nominal or even zero cost is not allowed to be sold, transferred or disposed of without first paying land use fees and converting it to "granted land."

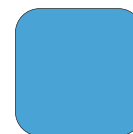
Licenses and permits.

It is critical that foreign buyers ensure at an early stage whether the target's licenses and permits can be renewed or reissued for the after-acquisition company. A foreign invested enterprise is subject to more stringent restrictions on business than domestic companies. Furthermore, prospective foreign buyers should check whether the target holds the required licenses and permits allowing it to engage in business activities. If the target runs its business without required licenses and permits, which is common, the foreign buyer must evaluate:

1. The possibility for the target to cure such defects;
2. How long it will take for the target to cure;
3. The possibility and cost for the foreign buyer to restructure the deal; and
4. The feasibility and possibility for the foreign buyer to apply for the required licenses and permits.

Environmental issues.

Compliance with local, provisional, and central government environmental laws and regulations is traditionally weak in many Chinese companies. This practice poses serious risks and liabilities for foreign buyers. In addition to civil damages and potential criminal prosecutions, the liability for cleaning up the contaminated property and reconstruction of environmental protection facilities can devastate the post-transaction company. Therefore, foreign buyers are advised to examine the target's waste/hazardous materials emission permits and the condition of the target's environmental protection practices and assess the compliance of the target with the applicable laws and regulations. Foreign buyers must keep in mind that just because the target can run its business without compliance with laws and local standards does not mean the post-acquisition company can operate in this manner. A foreign buyer does not have the well-established social network with local government officials as the target does,



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and a foreign buyer may never know the hidden arrangements the target entered into with the local environmental protection officials.

Intellectual property.

IP due diligence plays a key role in the overall due diligence process especially in the acquisition of a technology-intense target, as IP assets often comprise the majority of the value. For a foreign buyer, IP due diligence is more than simply gathering a list of the target's IP registrations, determining IP rights and ownerships, and reviewing IP-related contracts. Foreign buyers should carefully determine the value of a target's IP by linking such items to the target's sales and market share as well as assessing the IP of the target's competitors to determine whether the IP assets are overvalued or undervalued. In addition, the buyer needs to understand the concept of "employee-inventor rights" in China, whereby, under Chinese Patent Law, the company is required to pay certain rewards to employee-inventors. As part of the due diligence, the buyer should determine whether the target has complied with this law.

Periodic governmental filings compliance.

The foreign buyer should closely examine whether the target has filed its business license, foreign currency registration certificate, and other licenses and permits (depending on the target's registration location and industry). As previously stated, it is common in China for companies to operate outside of the scope of their business licenses and, therefore, operate illegally. In addition, many licenses and permits are not transferrable in the acquisition context. Expiration of these licenses and/or permits may result in monetary penalties, losing the qualification for conducting business, and even worse, the dissolution of the target.

Compliance with U.S. law.

Although a foreign buyer is faced with many novel cultural, operational, and regulatory challenges when pursuing an acquisition in China, a buyer must also be mindful of the target's future compliance with U.S. or other home-country laws. For U.S. companies, the Foreign Corrupt Practices Act (FCPA), the Sarbanes-Oxley

Act, and anti-trust laws are examples of compliance challenges facing Chinese subsidiaries of U.S. companies.

The FCPA includes two key components: the anti-bribery provision and record-keeping and internal controls provisions. The anti-bribery provisions of the FCPA prohibit corrupt payments of anything of value to foreign officials to retain business or to direct business to any person. The recordkeeping and internal control provisions obligate companies to maintain meticulous records and internal control systems and require them to report any failures or suspected violations, including those stemming from overseas operations.

In the case of an acquisition, a buyer can be held liable for violations committed by the target or its employees before the sale. In instances where potential buyers uncovered FCPA violations in the due diligence process, disclosure of the infraction to U.S. authorities may be sufficient to allow the deal to go forward. Failing to discover the FCPA violations may have more costly results. For potential U.S. buyers in China, the business environment creates some vexing compliance challenges. For example, determining precisely who qualifies as a 'foreign official' can be difficult, as the Chinese Communist Party has more than 70 million members who are highly integrated into every level of the economy. In addition, a buyer may find that certain business practices prohibited under the FCPA simply do not carry the same stigma in China. Clearly, sensitivity to any FCPA violations at every stage of the deal process must be a consideration for U.S. buyers.

Acquisition agreement and related documents. Once the foreign buyer is comfortable with the due diligence, the acquisition agreement and related documents are prepared and negotiated. The period starting from the execution of relevant acquisition agreements to the closing of the deal is a sensitive stage for both parties. At this stage, the foreign buyer is not the legal owner of the target and has no control over the target's business operation while the proposed deal is pending approval of the applicable Chinese government authorities. Conse-



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quently, a prudent foreign buyer should request the target to commit that:

- a. It shall make its best efforts to assist the foreign buyer in obtaining all necessary approvals, permits, and authorizations to close the deal;
- b. It shall diligently operate the business and maintain the goodwill of the target;
- c. It shall promptly notify the foreign buyer of any events that may have a material effect on the target's business;
- d. It shall maintain the good relationships with its employees, agents, distributors, clients, suppliers and any other parties who have business dealings with the target;
- e. It will not declare or distribute any dividends or make similar payments to reduce the amount of cash of the target; and
- f. It will not transfer, assign, pledge, or in any other way dispose its shares or assets during this sensitive stage.

In order to protect the foreign buyers' interests, it is recommended that foreign buyers request co-management of the target's company seal, which allows the foreign buyer to monitor and supervise the target's business operation, as the company seal is widely used in every aspect of daily operation of the target. Furthermore, when paying the purchase price, foreign buyers should consider the use of an escrow account to protect themselves.

Government approvals. Unlike the United States, Chinese government agencies are active in every transaction. Every acquisition must go through various examination and approval procedures to consummate the deal. A more detailed discussion appears later in this article.

Co-management of the target's corporate seals. The procurement of the government approvals takes time, ranging from 30 days to 120 days. During the interval, the buyer may be exposed to potential liabilities caused by the business decisions and activities of the target. Although the acquisition agreement may contain "material adverse change" provisions and certain other negative covenants, the buyer has already spent significant time and money on the transaction, and

terminating the deal is very difficult. As a result, the buyer should consider negotiating a co-management agreement, whereby the target will need the agreement of both parties to use the target's corporate seals. Since the appropriate seal must be affixed to contracts and other documents in order to make them valid in China, this approach offers a practical tool for a buyer to manage the risks arising between the time the purchase agreement is signed and the transaction closes. The target is likely to have a number of important seals, including a company seal (which bears the target's official company name), the legal representative seal (which bears the name of the legal representative of the target), and the special seal for finance (which is used in connection with any activities like publishing financial statements and dealing with banks and tax authorities). The above-mentioned three seals are very important to any company and cover nearly every aspect of the company's business operation. Some companies may establish special seals for contracts, invoices, or other special purposes according to their internal management rules. Negotiations over a co-management agreement include the types of seals covered and the situations in which the consent of both parties is required. Since these agreements restrict what the target can do, the negotiations over the co-management agreement can be very challenging.

Closing. After the documents are signed and government approvals obtained, the parties may finally close the transaction.

Conversion of the Chinese target to an FIE. After the closing, the target will be converted to either a wholly foreign owned enterprise ("WFOE") or an equity joint venture ("EJV"). Foreign buyers have to go through procedures for establishment of a WFOE/EJV, such as applying to the local branch of State Administration of Industry and Commerce ("SAIC") for a change of the business license, applying to the local branch of SAFE for foreign currency registration, and applying to the local tax authorities for tax registration, among others.

In Part II of this article, we will look at common difficulties and legal challenges as well as the role played by the Chinese government. ■