Considerations for American Companies in Chinese M&A Transactions
Joseph Norman

China is gradually opening up to the Western world, presenting attractive expansion opportunities for American businesses. Although communist in political philosophy, China passed Japan in 2010 to become the World’s second largest economy. Because of China’s rapid economic growth, companies in that market may be worthwhile targets for M&A transactions by American companies. Investing in a Chinese company, however, can be loaded with uncertainty—more so than domestic transactions in the United States.

Engaging in an M&A transaction with a Chinese company is more idiosyncratic than a typical transaction in the United States. Because of heavy government involvement in Chinese business, U.S. companies considering a transaction must not only adjust to unique cultural challenges of doing business in China, but they must also navigate multiple complicated layers of M&A regulation. China’s regulatory and business environment, like those in other emerging market countries, is in a state of flux. Since 2005, the Chinese government has made efforts to encourage M&A activity through adoption of new regulatory policies. U.S. companies, however, are finding out that recently promulgated laws and regulations contain legal uncertainty, ambiguity, and inconsistency. Discretionary approval of several different agencies and regulators may be necessary in a transaction depending on characteristics of the target, e.g., the industry sector; transaction type; the target’s business classification; whether the target is state-owned, privately owned by Chinese entities, or privately owned by foreign entities; and whether the target is publicly traded.

Closing an M&A transaction in China is a function of process. Each deal will be unique; therefore, a successful deal will depend on the executive team’s ability to manage each unique requirement using a clear and thorough process. That said—it is important to recognize that 70-80% of deals with Chinese companies will not move beyond the letter of intent. This commentary discusses considerations for American business executives contemplating an M&A transaction in China. The following five steps are baseline considerations for business executives.

**Step One: Screening and Selecting Targets**

Like all M&A transactions regardless of location, target selection is extremely important. Making the business case for investing in China is vital. If executive leadership lacks a clear goal for the integrated company post-transaction, then the resources expended in completing the deal may unfavorably shift the cost-benefit analysis. With a defined goal in mind, acquiring companies should set firm ground rules; because if deal fever overrides prudent planning and execution, it may be trapped in an unprofitable and unwanted transaction.

Engaging a local commercial consultant may be a U.S. company’s most important step towards a Chinese transaction. A local consultant will be able to more effectively screen and select high-priority candidates, because he is more likely to know and understand the intricacies of the relevant target industries. In this context, an ounce of bad deal prevention is worth a pound of expensive foreign investment cure. Once a target is selected, pre letter of intent communication with the target company is crucial. Reducing misunderstandings on deal terms and clarifying mutual goals in the transaction up front will speed up the transaction and increase the likelihood of closing.

**Step Two: Draw Up a Feasible and Realistic Deal Structure**

The best transaction structure is the most feasible and practical in light of China’s stringent regulatory requirements. The target’s characteristics, the degree of control sought, and post-transaction strategic goals are other critical considerations in structuring the transaction.
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The primary determinate of transaction structure will be the target’s characteristics: industry-sector classification; private entity or state-owned; and publicly traded or privately. The Chinese government maintains strict oversight of foreign investment projects. It classifies each industry into one of three categories based on their openness to foreign investment; investments are either “encouraged,” “restricted,” or “prohibited.” Encouraged industries include high technology, power, and development in China’s interior regions; restricted industries are less technological industries and industries gradually opening to foreign investors; and prohibited industries include those against the national interest such as potentially damaging to health, security, or the Chinese political state.

At the outset, it is important for U.S. executives to recognize that speed is a variable in Chinese transactions. Some transaction structures can be completed more quickly than others; therefore, timing goals with the deal structure that best meets the company’s needs. A foreign investor has four choices of deal structures in China—indirect equity purchase, direct equity purchase, asset acquisition, or statutory merger—all recognized under Chinese corporate law.

Indirect Offshore Equity Acquisition. U.S. business executives should favor an indirect offshore equity acquisition over other structures because it is the fastest and simplest transaction method. In this structure, the buyer acquires a Chinese-based subsidiary through an offshore parent company, usually based in Hong Kong. See chart below. Generally, offshore transactions are preferable to other structures because they are not subject to as many government approvals; because they avoid statutory pre-emptive rights of existing shareholders; and locating the acquired entity offshore allows for flexibility with tax implications.

Direct Equity Acquisition. An alternative to indirect equity acquisition is a direct equity acquisition, in which a foreign investor acquires shares directly in a Chinese company. Such direct investments are subject to discretionary approvals by China’s Ministry of Finance, and also trigger appraisal rights in the target’s other shareholders. Because of these hurdles, a direct acquisition takes three times longer than an indirect acquisition (thirty v. ninety days). Moreover, the government restricts foreign operations in China through foreign investment enterprise (“FIE”) regulations. When a foreign company acquires all of the equity in a purely Chinese entity, the foreign company must register as an FIE, and the acquired company will be subject to different operating rules than before the transaction. The change in regulation may make what would otherwise be a profitable and attractive transaction, infeasible.

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It should also be noted that share acquisitions in publicly listed companies are rare. Only in 2002 did the Chinese government begin to permit foreign investors to acquire shares in listed companies. Because this area of law is relatively undeveloped, government approvals and the regulatory obstructions are hard to predict with certainty. As of 2003, an investor may also acquire “legal person shares” in state-owned enterprises. Such stakes, however, are subject to significant government-imposed conditions including investor qualifications, justification of purpose, currency controls, and a twelve-month lock up commencing from payment in full. Given these considerations, transacting with a private non-listed Chinese company is quicker and easier than with listed companies.

Acquisition of Assets. Depending on the degree of control acquired through the purchase, asset deals may be subjected to significant regulatory burdens. Each deal of any size will be subject to a rigorous approval process by local authorities, and larger deals will require the approval of the Ministry of Finance, public notice to creditors, and appraisal for the target’s shareholders. Significant government lobbying may be required to complete an asset acquisition, and the government may force the acquirer to placate the target’s employees and creditors. Asset purchases, however, have the advantage of not automatically changing the legal status of the target post-transaction since the target may maintain its own separate legal existence, allowing for continuity in the target’s operations. Because of the regulatory burden, U.S. companies should utilize asset acquisitions only if an indirect equity acquisition is unavailable.

Statutory Mergers. Under Chinese merger law,2 mergers can use structures similar to those used in U.S. transactions: triangular, reverse triangular, and direct merger. Regardless of the method, in a statutory merger the acquirer takes all of the target’s assets and liabilities by operation of Chinese law. Mergers are subject to a multi-stage approval process at the local, national, and entity level that can be time consuming and expensive. Mergers are also subject to a variety of other costly requirements, e.g., the merger parties must make arrangements for original employees, creditors are given the statutory right to repayment or renegotiation, and the foreign investor must hold 25% of the combined company’s contributed capital. Because of these enhanced regulatory and transaction hurdles, mergers are often the slowest transaction type and should be avoided by U.S. companies looking to gain entry into the Chinese market.

Step Three: Due Diligence

Conducting a thorough due diligence process is likely the most important step in a successful Chinese M&A transaction. Completely understanding the Chinese market and local Chinese business customs can be very difficult for U.S. business executives; therefore, it is essential to find experienced local advisers to perform thorough due diligence. Any professional adviser should have experience performing due diligence in the location of the target, must speak Mandarin, and should know local business practices and culture. Although legal due diligence is always crucial to the deal, the executive team should perform accounting due diligence, operational due diligence, and regulatory due diligence as well.

Beyond corporate law issues that would also arise in a domestic U.S. transaction, legal due diligence in China should investigate whether the company has committed any illegal conduct, whether it has avoided any customs duties or taxes and whether it is properly registered with the Chinese government. One particularly relevant issue in China is the need to identify the target’s legal representative. Legal representatives in Chinese companies have automatic power to act for the company.

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Authorizations given by the legal representative are binding on the corporation and any future purchaser. As a result, it is imperative to for an acquirer to obtain a full record of all authorizations the representative has given.

Legal due diligence ties in with accounting due diligence. It is not uncommon for foreign investors to discover certain liabilities that are not disclosed in legal documents through accounting due diligence. Furthermore, most Chinese companies maintain multiple sets of accounting records for separate purposes—one for taxes, one for dividing ownership interests, and still another for operations. Because Chinese law does not require companies to have audited financial statements, it will be important to work with the target’s accountants to verify and reconcile financial statements against reality.

The importance of operational and regulatory due diligence should not be overlooked. Foreign investors need to be absolutely certain as to what they are getting when purchasing the company. For instance, China has specific intellectual property and real estate transfer restrictions that may separate rights to those assets from the target company. Moreover, an acquiring company needs to have a complete understanding of the company’s profit making and development potential in order to assess the deal’s value from a commercial standpoint. Operationally, U.S. executives should understand the business activities authorized in the company’s business license and/or articles of association, and activities in which the company actually engages. Often Chinese companies do not comply with legal formalities, but—buyer be warned—foreign investors are not likely to operate with the same impunity. Lastly, regulatory due diligence should include hiring a local agent who has a relationship with relevant governmental authorities. Agents are likely to know application barriers and, based on their government relationships, they may be able to reduce the likelihood of rejection or clear up any misunderstandings during the approval process.

<table>
<thead>
<tr>
<th>Factors that Influence the Scope of Due Diligence</th>
<th>Less Due Diligence</th>
<th>More Due Diligence</th>
</tr>
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<tbody>
<tr>
<td>Seller is financially strong</td>
<td>Seller is financially weak; state of seller’s finances unknown</td>
<td></td>
</tr>
<tr>
<td>Seller is willing to provide strong reps and warranties and/or offshore escrow</td>
<td>Seller unwilling to accede to strong reps and warranties or escrow</td>
<td>Seller will not agree to escrow agreement; presence of factors making non-compete effective</td>
</tr>
<tr>
<td>Reps and warranties survive closing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling entity survives closing</td>
<td>No surviving entity</td>
<td></td>
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<tr>
<td>Large amount of publicly available information</td>
<td></td>
<td>Business venture has very little margin for error</td>
</tr>
<tr>
<td>Buyer knows the business/industry/market well.</td>
<td></td>
<td>Business is located in a country where it may be difficult to enforce legal action</td>
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Step Four: Drafting the Deal Documents

Because information about the target may remain imperfect no matter how much due diligence is performed, drafting protection into the terms of the deal is essential. Representations and warranties are a U.S. company’s most important protection in a Chinese transaction. As previously mentioned, it is not uncommon for acquirers to discover hidden liabilities or illegal conduct post-closing; reps and warranties allow an acquirer to avoid those risks. Also, U.S. executives may want to consider drafting an exit option into the transaction document, thereby giving a contractual out if unforeseen or non-disclosed events occur. Another important consideration is the ineffectiveness of non-compete agreements in China. Such agreements may be difficult to enforce against a Chinese seller, especially if the seller has government relationships. As a result, acquirers should utilize more definite remedies like a liquidated damages clause or an escrow held offshore.

Step Five: Regulatory Approval and Business Registration

Regulatory burdens on M&A transactions in China are much heavier than those placed on transactions in the United States. By contrast though, a Chinese transaction is less likely to be challenged by shareholders after the transaction, as might be the case in the U.S.

Depending on transaction characteristics, e.g. the deal structure, the target type, and the transaction value, many Chinese regulatory agencies may have to give transaction approval. As previously mentioned, the first step in a Chinese M&A transaction is learning the government’s classification of the target industry. Only targets in the “encouraged” or “restricted” industries will be free to pursue a transaction. Once the transaction clears the classification hurdle, the deal will be subject to oversight by the Ministry of Commerce (“MOFCOM”) and the State Administrations of Industry and Commerce (“SAIC”). All transactions must be approved by these two agencies. MOFCOM administers China’s M&A laws and is the principal foreign investment regulator. After gaining MOFCOM approval, the foreign acquirer must register with the SAIC. In this role, the SAIC is the actual agency with approval authority.

Additional approvals may also be required depending on the nature of the transaction. If a target is a state-owned entity the State-Owned Assets Supervision and Administration Commission (“SASAC”) may be involved either as an approval authority or as a vendor, or if a target is publicly listed, approval will be required from the China Securities Regulatory Commission (“CSRC”), which oversees China’s capital markets. In addition to these regulators, certain industries have their own oversight regimes that will also have to approve the transaction. For example, the Ministry of Information Industry will have to approve transactions in the consumer electronics industry. Finally, a deal may also be subject to anti-trust review under the recently promulgated Anti-Monopoly Law.

This regulatory maze is further complicated by the fact that regulatory agencies might not work in tandem, requiring the acquirer to seek independent approval from many different agencies. Furthermore, approval from one agency does not ensure approval from others. The importance of regulatory due diligence and establishing professional advisors that can help shepherd the deal through the regulatory process, cannot be overemphasized.
Other Considerations

Two final considerations are worth mentioning: human resources issues and the accuracy of valuations. Some private Chinese companies may not pay employees overtime, may underpay income tax or social insurance taxes, or may pay salaries to certain employees without recording the payments. As a result foreign acquirers should recognize that true operating costs might differ significantly than reported. Business plans will have to account for this possibility.

If the acquirer chooses to pursue a transaction with a state-owned enterprise, determining the correct valuation of the enterprise may become an issue. State-owned companies commonly conduct transactions on non-arms-length terms. Acquirers should recognize that the target’s earnings might change significantly once related-party transactions are excluded or restated at fair value.

Conclusion

China’s economy continues to expand at over 10% per year; therefore, the Chinese market offers great potential as a target country for U.S. companies seeking growth opportunities. U.S. business executives should be prepared to meet the uncertainties of a transaction in China in an informed, flexible, and creative manner. Executives with a solid understanding of the regulatory burdens, market opacity, and due diligence requirements have a greater chance of successfully closing an M&A transaction with a Chinese target.

Sources


