

# **Antitrust Considerations in China Mergers**

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The WTO has tentatively placed competition policy on its agenda, and it has become a trend among nations to establish competition law regimes, particularly relating to mergers and acquisitions. The People's Republic of China is one of those jumping on the antitrust bandwagon.

On April 12, 2003, Provisional Rules for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors became effective.<sup>1</sup> These Provisional Rules were issued at the First General Meeting of the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) on January 2, 2003, and contain four articles that appear to be intended to apply competition policy considerations, among others, to foreign investments in China. In addition, for several years, a working group has been drafting an Anti-Monopoly Law that contains provisions applicable to all mergers and acquisitions in China.

This paper summarizes the aspects of the Provisional Rules and the proposed Anti-Monopoly Law relating to concentrations, and discusses some concerns raised by these provisions. It concludes with reservations about the appropriateness at this time of implementing competition laws in China.

## **Provisional Rules for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (Articles 19-22)**

The stated goals of the Provisional Rules are to “encourage and regulate investments by foreigners in China, introduce foreign advanced technology and management experience, raise the level of utilization of foreign investment, realize the reasonable allocation of resources, secure employment and maintain fair competition and the economic security of the State.” (Article 1.) The Provisional Rules require certain acquisitions of businesses in the People's Republic by foreign enterprises to be subject to review for various considerations, including whether the transactions may “exclude or restrict competition,” or may lead to “over-concentration.” (Article 3.)

Article 19 of the Provisional Rules requires notification by a foreign investor to MOFTEC and the State Administration for Industry and Commerce (SAIC), of an acquisition by the investor in China, if:

- (1) any party to the transaction has current annual revenues of over RMB 1.5 billion in the Chinese market;

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<sup>1</sup> An unofficial English translation of the Provisional Rules is annexed to this paper, by courtesy of O'Melveny & Myers. The quotations and summaries of specific portions of the Provisional Rules in this paper are based on the writer's reading of the original Chinese text.

- (2) the foreign investor has acquired more than 10 enterprises in related industries in China within a year;
- (3) any party to the transaction has a share of the Chinese market of at least 20%; or
- (4) the transaction will result in a party holding at least 25% of the Chinese market.

The Article also provides that MOFTEC or SAIC may still require a report even if none of the 4 prerequisites are present, if there are requests by Chinese competitors, relevant authorities or industrial associations and MOFTEC or SAIC determines that the transaction may affect a substantial part of the market or may have other substantial effects such as on market competition or the national interest and economy security of the country.

Article 20 provides that, if a transaction meets any of the 4 conditions in Article 19, and MOFTEC and SAIC determine that the transaction may result in excessive concentration, or injure proper competition or consumer welfare, then, within 90 days of receiving the required documentation from the parties, MOFTEC and SAIC shall jointly, or one of them after consultation with the other, hold a hearing to which relevant departments, agencies, enterprises and other interested parties are invited, and determine pursuant to law whether to permit the transaction.

Article 21 provides that, if any of 5 conditions are met, then, before the public announcement of the transaction plan or simultaneously with notification to the relevant authorities of the home country of the foreign investor, the parties must file the transaction plan with MOFTEC and SAIC. MOFTEC and SAIC will investigate whether the transaction has the potential to result in over-concentration in the domestic market, or injure proper competition or consumer welfare domestically, and make a determination on those issues. The 5 conditions are:

- (1) any party to the transaction has assets in China of over RMB 3 billion;
- (2) any party to the transaction has current year revenues from businesses in the Chinese market of over RMB 1.5 billion;
- (3) any party to the transaction, together with its affiliated enterprises, have at least 20% of the Chinese market;
- (4) as a result of the transaction, any party to the transaction, together with its affiliated enterprises, will have at least 25% of the Chinese market; and
- (5) as a result of the transaction, any party to the transaction will, directly or indirectly, hold investments in over 15 Foreign Investment Enterprises in related domestic industries.

Article 22 provides that any party to a transaction that meets any one of 4 conditions may apply to MOFTEC and SAIC for an exemption from investigation. The conditions are:

- (1) the transaction can improve the conditions for fair market competition;
- (2) the transaction will reorganize an enterprise that is operating at a loss and secure employment;
- (3) the transaction will introduce advanced technology and management talent, and will raise the international competitiveness of the enterprise; and
- (4) the transaction may improve the environment.

### **Proposed Anti-Monopoly Law (Articles 25-30)**

The proposed Anti-Monopoly Law devotes Chapter 4, containing Articles 25 through 30, to “Control of Enterprise Concentrations.”

Article 25 defines “enterprise concentrations” to mean where:

- (i) one or more than one enterprise merge(s) into an existing enterprise or more than 2 enterprises combine to become a new enterprise;
- (ii) one enterprise gains control over another enterprise through the purchase of shares or assets of the other enterprise;
- (iii) two or more enterprises agree to an agency or a joint venture or other method to form a controlling and controlled relationship.

Article 26 provides that application for approval of a concentration must be submitted to the Anti-Monopoly Management Body of the State Council that will be formed under the new law, if the annual sales of the parties to the transaction exceed limits that will be established by the new agency.

Article 27 lists the required contents of such applications:

- (i) the status of the business operators, including the names of the enterprises, addresses, the products produced or sold, number of staff, the total assets, the net assets, the annual turnover of the previous year, the profit tax status, etc;
- (ii) the financial report and sales report of the previous accounting year of the business operators;
- (iii) information on the product production or operation costs, selling prices and quantities produced etc. of relevant products of the business operators;
- (iv) the effect that the concentration may have on the national economy and public interest;
- (v) the reasons for the concentration;
- (vi) other documents required by the Anti-Monopoly Management Body of the State Council.

Article 28 provides that the Anti-Monopoly Management Body of the State Council shall decide whether to grant approval within 90 working days of receiving the documents submitted by the business operators pursuant to Article 27. The Body may impose conditions on its approval of a concentration. Article 28 also provides that “Under special circumstances, the review period may be extended.”

Article 29 requires the Anti-Monopoly Management Body of the State Council not to approve any concentration that:

- (i) eliminates or limits market competition;
- (ii) hinders the healthy development of the national economy; or
- (ii) damages the public interest.

Article 30 authorizes the Anti-Monopoly Management Body of the State Council to give special approval to concentrations that eliminate or limit market competition within a specified sphere if they are advantageous to the national economy and the public interest.

## **Concerns**

This paper discusses 3 general categories of concerns raised by these provisions in the Provisional Rules and the proposed Anti-Monopoly Law: (1) the interactions between the provisions in the two laws; (2) the substantive standards established by the laws; and (3) the procedural aspects of the provisions.

### **Interaction between the Provisional Rules and the Proposed Anti-Monopoly Law**

The Provisional Rules establish standards for foreign investments in China, and apply a wide range of criteria for determining the permissibility of such investments, ranging from national security, to employment, to competition. The proposed Anti-Monopoly Law is apparently intended to apply competition policy to all conduct and concentrations within China, whether a foreign investor is involved or not.

To the extent the Provisional Rules establish different standards for considering the competition implications of acquisitions by foreign investors than the standards that will be applied under the proposed Anti-Monopoly Law to all acquisitions within the People’s Republic, World Trade Organization obligations of non-discriminatory and national treatment may be implicated. In order to avoid complications under the WTO obligations of non-discrimination and national treatment, the better course would be to provide that the competition policy review of concentrations be made only under the proposed Anti-Monopoly Law, regardless of whether the concentrations involve foreign investors, while the review of acquisitions by foreign investors under the Provisional Rules should be restricted to consideration of non-competition policy factors such as

“economic security of the State,” “employment” and the “community economic order or community public interest”. The Provisional Rules should be amended to delete consideration of competition factors in the review of transactions under those Rules.

This bifurcation is an approach common to countries such as Canada and the United States. In Canada, the Investment Canada Act applies to foreign investments various non-competition policy considerations. Canada’s Competition Act, enforced by the Competition Bureau of Industry Canada, is applied to all commercial activity, including concentrations, in Canada, regardless of the nationality of the parties. Similarly, in the U.S., the Exon-Florio Act applies national security considerations to foreign investments in the U.S., while the Clayton Act applies competition policy to all concentrations in the U.S., regardless of the nationality of the parties.

Such a centralization under the proposed Anti-Monopoly Law of competition review of concentrations will avoid the complications of having potentially different competition policy standards being applied by different agencies to concentrations involving foreign investors than to concentrations involving only domestic parties. It will also avoid the potential of some transactions being required to satisfy the disparate competition policy standards of two different laws. Finally, it will also facilitate the evaluation of the consumer welfare and efficiency effects of transactions under competition policy without the complications of attempting in one analysis to include such diverse factors as national security and employment opportunities that are not susceptible to economic analysis in the same way that investigations of consumer welfare and efficiency effects are.

### **The Substantive Standards**

The substantive standards that are contained in the two sets of provisions raise concerns both in terms of what they contain and what they omit. They contain factors that, at best, are irrelevant to competition policy goals of consumer welfare and efficiency, and, at worst, are inconsistent with those goals. They omit any meaningful standard under which the enforcement authority can determine if a concentration has the potential to injure competition.

The Provisional Rules authorize MOFTEC and SAIC to investigate transactions that may affect a substantial part of the market or have substantial effects on market competition, and to prohibit transactions that may result in excessive concentration or injure consumer welfare. The proposed Anti-Monopoly Law prohibits concentrations that eliminate or limit market competition. These are concerns that are at the core of competition policy.

However, the Provisional Rules also authorize MOFTEC and SAIC to investigate transactions that may affect “the national interest and economic security of the country.” They expressly exempt from investigation potentially anti-competitive concentrations that will reorganize unprofitable enterprises, preserve jobs, “introduce advanced

technology and management talent,” and “improve the environment.” Similarly, the proposed Anti-Monopoly Law prohibits concentrations that hinder “the healthy development of the national economy” or “damage the public interest” while permitting anticompetitive concentrations that are “advantageous to the national economy and the public interest.”

The goals of efficiency and consumer welfare are the goals of competition law. “Consumer welfare” in this context means the welfare of all entities, including governmental entities and business operators, not just individuals, that purchase and consume products and services. It is distinct from “consumer protection”; “welfare” refers to the quality, prices and choices available and the most efficient allocation of scarce resources to satisfy demand, while “protection” is directed against unfair, deceptive or fraudulent practices that distort consumers’ ability to choose freely and knowledgeably among various product and service options in the marketplace. Fraud is the most egregious example of such unfair competition.

National interest, economic security, technology transfer, jobs preservation, the environment and the public interest may be important policy considerations. However, they are better addressed in laws that do not relate to competition policy. The promotion of competition, which is at the core of competition policy, focuses on efficiency and consumer welfare. The promotion of competition in terms of efficiencies is the fundamental and necessary competition policy objective most suited to economic analysis. Economic analysis is therefore a critical and necessary element of competition law application and enforcement. Objectives such as encouraging and regulating foreign investment, introducing foreign advanced technology and management experience to China, securing employment and maintaining the economic security of the State are not objectives that lend themselves to economic analysis. These objectives reflect social and political objectives which are best sought through either (a) separate legislation or established rules rather than as factors to be considered in individual antitrust cases, or (b) an analysis that is clearly distinct from the economic analysis required by the objective of promoting competition.

Therefore, the better course would be to omit all competition policy goals from the Provisional Rules, to omit all non-competition policy goals from the proposed Anti-Monopoly Law, to have the Anti-Monopoly Law establish the competition policy standards for all concentrations (regardless of the nationalities of the parties) and to incorporate non-competition policy goals that are omitted from the proposed Anti-Monopoly into other laws which are focused on those other goals.

The omissions in the laws are at least as troubling as the inclusions. The Provisional Rules contain no definition of key concepts such as “market”, while the definition of “market” in the proposed Anti-Monopoly Law<sup>2</sup> does not have recognizable connections to pre-existing common usage and may not be susceptible to practical application. It defines a market in purely geographic terms, without reference to the

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<sup>2</sup> “A ‘specific market’ in this law means the territorial area affected during a limited time period by the sales of particular products by business operators.” (Article 4.)

product dimension of a market. This definition should be replaced with one that includes generally accepted concepts of substitutability and cross-elasticity of demand. For example, it would be more consistent with generally accepted economics principles to define a “specific market” to be “a group of products (or services) which buyers do or would consider substitutes for each other, and the geographic area in which such products (or services) are sold by specific business operators and their competitors.”

The definition of “enterprise concentration” in the proposed Anti-Monopoly Law is both over-inclusive and under-inclusive. For example, the definition is under-inclusive since it doesn’t appear to cover situations where an enterprise that produces different products sells the assets that manufacture some of those products but retains the manufacturing capability to produce other products. It may be over-inclusive in that any agency relationship may be said to involve a controlling and controlled relationship with respect to the subject of that agency. Moreover, it would also be helpful to have clarification as to what types of joint ventures may constitute a concentration.

The key concept of “control” is not defined in either law, although the Provisional Rules contain detailed provisions regarding what types of investment are subject to the Rules. A possible definition of “control,” based on the regulations under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, is “(1) holding 50% or more of the outstanding voting securities of an issuer, (2) in the case of an entity that has no outstanding voting securities, having the right to 50% or more of the profits of the entity, or having the right in the event of dissolution to 50% or more of the assets of the entity, or (3) having the contractual power to designate 50% or more of the directors of a corporation, or, in the case of unincorporated entities, of individuals exercising similar functions.”

Finally, there is no guidance in either the Provisional Rules or the proposed Anti-Monopoly Law as to when a concentration will be found to injure, eliminate or limit competition, injure consumer welfare or result in excessive concentration, and therefore will be prohibited. There are two principal standards in use in other competition law regimes. In the U.S., mergers that substantially lessen competition are illegal. In the European Community, mergers that create or extend a dominant position are prohibited. In the U.S., efficiencies that may come about specifically as a result of a concentration are considered and balanced against the potential anticompetitive effects of that concentration.

On the other hand, Article 22 of the Provisional Rules arguably gives rise to the inference that transactions are presumed to be anticompetitive under the Provisional Rules if they satisfy any of the 9 conditions in Articles 19 and 21, and places substantial burdens on parties that are difficult to justify on competition policy grounds. Article 22 permits parties to present mitigating factors to obtain exemptions from the investigations that are required under Articles 19 and 20 if any one of 9 conditions are met. Therefore, if any of the 9 conditions are met, the parties must present competition defenses such as increased competitiveness and failing companies, or non-competition defenses such as job preservation, introduction of advanced technology and improvement of the

environment, or be faced with potentially onerous and open-ended investigations. However, there are little reason to suppose that the 9 conditions are significant predictors that a transaction is likely to be anti-competitive. For example, if a transaction is reportable merely because a party has annual revenues in China of over RMB 1.5 billion, the transaction may have *no* impact on competition at all. Yet, Article 22(1) would require the party to show that the transaction may increase competition or rescue a failing business, if not preserve jobs, introduce advanced technology or improve the environment, in order to avoid an investigation. The requirement to present such “defenses” before any investigation is conducted, is premature and burdensome in the circumstances. Moreover, it is debatable that competition law should seek to *increase* the level of competition in the marketplace, as opposed to maintaining, or preventing a decrease in, the level of competition.

In the U.S. and the EC, factors such as failing companies are not considered at all until an investigation has tentatively concluded that the transaction is likely to decrease competition in the marketplace. And factors such as technology introduction and the environment are not considered mitigating factors under U.S. or EC competition law at all, but are addressed separately under other laws.

### **Procedural Concerns**

There are both over-arching concerns regarding the implementation in China at this time of a competition law regime, and specific procedural concerns raised by the particular provisions in the Provisional Rules and the proposed Anti-Monopoly Law.

A competition policy enforcement framework involves the creation and maintenance of very complex rules and institutions, and the application of expertise in a variety of legal disciplines such as competition law, administrative law, appellate law, and procedural and evidentiary rules, and in economics subjects such as industrial organization theory and econometrics. It also requires a sophisticated legal system that can enforce effectively and in a timely and objective manner all substantive, procedural and remedial standards. Such a legal framework should have at least the attributes of transparency in substance and in process, adequate protection of confidentiality, processes for petitioning the enforcement agencies for action, independent and competent investigating agencies, objective and critical evidentiary rules, timely, thorough, independent and balanced investigations and prosecutions, full disclosure to targets of investigations of the allegations and the bases for the allegations of violations, remedies that are appropriate to the offense, and judgments that are subject to neutral and timely review. It is unclear that all of these procedural prerequisites are met in China at this time.

As to the specific provisions of the Provisional Rules, unless there is further guidance from MOFTEC and/or SAIC as to how the Rules are to be implemented, the authorities may be overwhelmed with applications that are clearly of little importance and

parties entering into transactions may be at a loss as to how to comply with Articles 19 and 21 and as to how those articles, and Articles 20 and 22, will actually operate.

First, to a large extent Article 19 and Article 21 are redundant. Any transaction that satisfies any of the conditions of one of the articles will often satisfy one or more conditions of the other article. Therefore, in most cases, parties that must file a “report” under Article 19 will also need to file the transaction plan under Article 21, and *vice versa*. Yet, because the processes that follow a report under Article 19 are apparently different from those that follow the filing of a transaction plan under Article 21, there is the potential for conflict and confusion as to which is the appropriate process in a particular circumstance. For example, if filings are made under both Article 19 and Article 21, and MOFTEC and/or SAIC decide under Article 21 that the transaction may be anticompetitive and issue a decision accordingly, is a hearing within 90 days of the report under Article 19 still required? To what purpose?

The interaction between Article 19 and Article 20 is also unclear. Article 20 requires a hearing to be held within 90 days of receipt of the report that is required in the event any of the 4 conditions in Article 19 are met, if MOFTEC and SAIC determine that the transaction may have anti-competitive effects. However, it is unclear whether a similar hearing is required under Article 20 when the 4 conditions of Article 19 are not met but a report is required by MOFTEC and/or SAIC.

Moreover, without a *de minimis* requirement in Article 19(2) or Article 21(5), or any guidance as to what might be considered “related industries”, parties may, to be prudent, file notification whenever they have made more than 10 transactions in the last 12 months, regardless of the size and likely competitive significance of those transactions. For example, if a foreign investor, with an existing manufacturing facility in China, acquires several small suppliers of parts to the manufacturing facility and several distributors of the products manufactured by that facility, that investor may be required to file an application for its most recent transaction, even if all of the earlier transactions involve entities whose revenues do not add up to, say, RMB 1.5 billion. In the experience of the U.S., most such “vertical” transactions raise few competition concerns.

Similarly, without any guidance as to what is meant by a “market” for the purposes of the Provisional Rules, it may be difficult for a foreign investor to determine whether any party to a transaction holds 20% of the “Chinese market” or whether the transaction will result in any party holding 25% of the “Chinese market”. In contrast, the proposed Anti-Monopoly Law provides that application for approval of a concentration must be made when the annual sales of the parties exceed limits to be set by the Anti-Monopoly Management Body of the State Council.

In both the U.S. and the EC, the determination of when notification is required turns entirely on readily ascertainable factors such as the amount and location of the assets and revenues of the parties, without reference to the products, services, markets or market positions involved. This permits parties to determine whether a notification is

required without the uncertainties of a competition analysis that may require consideration of many complex and ambiguous factors. The requirement of notification is separated from any consideration of the competition impact of the transaction being notified.

The time frames involved are unclear. Nowhere does Article 19 indicate when any required report should be filed with MOFTEC and SAIC. In the case of Article 21, suppose a transaction meets one of the 5 conditions, but is not publicly announced and does not require a notification to the home country of the foreign investor. It is unclear when the filing required by Article 21 must be made in those circumstances. Or, is the inference that no filing needs to be made in those circumstances?

There is no requirement in Articles 20 or 21 as to when MOFTEC and/or SAIC must make a decision, or even whether both or only one of them must make a decision, regarding the permissibility of the transaction. Delays often mean the demise of the transaction. Such a potentially open-ended review period offers the possibility that MOFTEC and/or SAIC may effectively prohibit a transaction merely by prolonging the investigation, without any need to complete an investigation or issue a finding that the concentration is anticompetitive that can then be subject to review. Therefore, it is important to set deadlines for government action. In addition, it would be beneficial to specify whether any approval is *ex post* or *ex ante*.

With respect to the contents of the application required by Article 19, the Provisional Rules do not specify what the reports that the parties must file should contain, while the proposed Anti-Monopoly Law requires more than a competition policy review needs. The applications should not be required to discuss “the effect the concentration may have on the national economy and public interest” because a competition law review should not consider whether concentrations “hinder the healthy development of the national economy” or “damage the public interest”.

For its part, the proposed Anti-Monopoly Law is silent regarding the organization of the Anti-Monopoly Management Body of the State Council, and the method of appointment, terms of service and status of the members of the Body, along with the independence of the Body from improper influence. There are also no details regarding the processes for investigations, adjudications and appeals before the Anti-Monopoly Management Body of the State Council. The procedures that MOFTEC and SAIC will follow under the Provisional Rules are similarly unclear.

As with the open-ended review period in the Provisional Rules, the potentially open-ended review period provided in the proposed Anti-Monopoly Law is unworkable. A review period should be extended only once, and for no longer than a specified period, say, 30 days beyond the 90 days already provided. The types of “special circumstances”, such as a preliminary finding of areas of competition concern and the need to obtain information from third parties, that would justify an extension should also be identified.

## **Conclusion**

The serious concerns that are raised by the competition aspects of the Provisional Rules and the provisions relating to concentrations in the proposed Anti-Monopoly Law argue for significant revision of the Rules and substantial redrafting of the proposed law before enacting it.

More fundamentally, it is unclear whether competition policy should be an urgent priority of China at this point in time. Competition policy presupposes a commitment to a market economy in which competitive forces operate freely. Creating market competition requires substantial infrastructure and support from other governmental institutions and the society at large, and cannot be achieved by the enactment and attempted enforcement of a competition law alone. There is some consensus that certain pre-conditions are needed in order for market competition to exist and for a successful competition law regime to be implemented. These preconditions include general security and stability sufficient to permit the creation and maintenance of a market system, broad support from all sectors for having market competition be the organizing principle for substantial sectors of the economy, and economic infrastructure that includes, at minimum, a functional financial system, a functional system of property rights and their definition, protection and transfer, a functional system of enforcing commercial arrangements, and a functional system for creating and governing common business organizations such as corporations, partnerships and cooperatives.

It is unclear how many of these preconditions are met in China. Until most, if not all, of these preconditions exist, there may be other priorities that should take precedence in the development of legal institutions in China, rather than the premature and hasty implementation of poorly-conceived and poorly-drafted laws that may be counterproductive and may simply add layers of state intervention in private enterprise and punish efficient businesses rather than serve competition policy goals.

## **Provisional Rules For Mergers and Acquisitions of Domestic Enterprises By Foreign Investors**

*(Passed at the First General Meeting of the Ministry of Foreign Trade and Economic Cooperation on January 2, 2003, and promulgated hereby for implementation as of April 12, 2003)*

### **Article 1**

These Rules are formulated in accordance with the laws and administrative regulations concerning foreign invested enterprises (hereinafter referred to as "FIEs"), and other relevant laws and administrative regulations, in order to encourage and regulate foreign investments in China, introduce foreign advanced technology and management experience to China, raise the level of utilization of foreign investment, realize the proper allocation of resources, secure job opportunities and maintain fair competition and economic security of the State.

### **Article 2**

Mergers and acquisitions ("M & A" or "M/A") of domestic enterprises by foreign investors in these Rules refers to foreign investors' purchasing by agreement the equity interests in or subscribing to the capital increase of a non-foreign invested enterprise in China (hereinafter referred to as a "Domestic Enterprise"), thus changing the Domestic Enterprise into an FIE (This method is hereinafter referred to as "Equity Acquisition), or foreign investor's establishing an "FIE" to purchase and operate by agreement the assets of the Domestic Enterprise through the FIE, or, foreign investors' purchasing by agreement the assets of a Domestic Enterprise, and using such assets as investment to establish an FIE to operate such assets (This method is hereinafter referred to as "Asset Acquisition").

### **Article 3**

M & A of Domestic Enterprises by foreign investors must be carried out in accordance with laws, administrative regulations and department rules of China, shall comply with principles of fairness, reasonableness, mutual consideration and good faith. It shall not result in any over-concentration of investment, exclusion or restriction of competition, nor shall it disrupt the economic order or harm public interest.

### **Article 4**

M & A of Domestic Enterprises by foreign investors must comply with requirements with respect to the qualification of the investor and industry policy in the laws, administrative regulations and department rules of China.

With respect to industries in which wholly foreign owned enterprises are not allowed under <The Foreign Investment Industrial Guidance Catalogue>, the M & A shall not result in any 100% ownership by foreign investors. With respect to industries in which control or majority ownership by the Chinese party is required, the Chinese party shall remain to be the majority shareholder or controlling shareholder after the M & A. With respect to industries to which foreign investments are prohibited, no M & A by foreign investors is allowed.

#### **Article 5**

When a foreign investor merges with or acquires a Domestic Enterprise to establish an FIE, it shall have the approval of the examination and approval authority in accordance with these Rules, and shall complete the registration for the change or establishment of the FIE with the registration authority. After such M/A, the foreign investor's contribution shall be no less than 25% of the registered capital of the FIE. If the foreign investor's contribution is less than 25%, unless otherwise specified by laws or administrative regulations, the approval and registration shall be completed according to the existing rules for the establishment of an FIE. The examination and approval authority shall mark such approval certificate with the words "Foreign Investment Less Than 25%", and the registration authority shall mark the Business License of the FIE with the words "Foreign Investment Less Than 25%".

#### **Article 6**

The examination and approval authority in these Rules is the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC") of the People's Republic of China or the provincial authority in charge of foreign trade and economic cooperation (the "Provincial Approval Authority"), and the registration authority shall be the State Administration of Industry ("SAIC") or its authorized local offices.

If the FIE established after the M/A is of a special type or in an industry which requires approval by MOFTEC according to laws, administrative regulations and department rules, the Provincial Approval Authority shall forward the application documents to MOFTEC, which will decide whether to approval in accordance with the law.

#### **Article 7**

When a foreign investor undertakes an Equity Acquisition, the FIE established because of such acquisition shall inherit the rights and obligations of the acquired Domestic Enterprise Company.

When a foreign investor undertakes an Assets Acquisition, the Domestic Enterprise selling its assets shall continue to exercise its existing rights as a creditor and to assume its existing obligations as a debtor.

The foreign investor, the acquired Domestic Enterprise, the creditors and other interested parties may otherwise deal with the rights and obligations of the acquired Domestic Enterprise by agreement, but such agreement should not harm any third party or public interest. Agreement on rights and obligations shall be submitted to the examination and approval authority.

Within 10 days after the date of its resolution regarding sale of its assets, the selling Domestic Enterprise shall serve notice on its creditors, and shall make public announcement in a newspaper which is at or above provincial level and which has a nationwide circulation. Within 10 days after the receipt of such notice or the publication of such announcement, the creditors shall be entitled to demand that the selling Domestic Enterprise provide relevant security for the debt.

### **Article 8**

The parties to the M & A shall determine the price of the transaction on the results provided by an asset evaluation agency with regard to the value of the equity interest to be transferred or the value of the assets to be sold. The parties to the M & A may decide by agreement on the choice of an asset evaluation agency duly established in China. Evaluation shall be conducted by internationally accepted methods.

When the M & A results in a change in the shareholding of assets which were invested as state-owned assets, or the transfer of title to such state-owned assets, the transaction price shall be determined on the basis of an evaluation conducted in accordance with the relevant provisions of state-owned asset management.

It is prohibited to transfer assets abroad in disguise, i.e., by means of equity interest transfer or asset sale at a price markedly below the price based on said evaluation.

### **Article 9**

When foreign investors merges with or acquires a Domestic Enterprise to establish an FIE, it shall pay the whole price to the transferring shareholder or the selling Domestic Enterprise within three months after the business license of the FIE is issued. When circumstances warrants an extension and by the approval of the examination and approval authority, at least 60% of the total price shall be paid within 6 months and 100% within a year after the issuance of the business license. Profit shall be distributed in accordance with the percentages of actual contributions.

When the foreign investor undertakes an Equity Acquisition, and the FIE established after such acquisition will increase its capital, the investors shall provide for the term of such capital contribution in the contract and articles of association of the contemplated FIE. If the capital increase is to be paid as a lump sum, the investors shall make full payment within 6 months after the business license is issued. If payment is by installments, the first installment by each investor shall be no less than 15% of its committed contribution, and shall be paid within 3 months after the business license is issued.

When the foreign investor undertakes an Asset Acquisition, the investors shall provide for the term of payment in the contract and articles of association of the contemplated FIE. When an FIE is established to purchase and operate by agreement the assets of a Domestic Enterprise, the part of price equivalent to the value of such assets shall be paid by the investor within the period prescribed in paragraph 1 of this article, and the remaining part shall be paid within the period prescribed in paragraph 2 of this article.

When foreign investors merges with or acquires a Domestic Enterprise to establish an FIE, and the foreign investor contributes less than 25% of the capital, full payment of such contribution shall be made within 3 months after the business license is issued if contribution is made in cash, and within 6 months after the business license is issued if contribution is in the form of physical property or industrial property rights.

All payment method of purchase consideration shall comply with relevant laws, administrative regulations of the State. When the purchase consideration by a foreign investor is in the form of stock of which such foreign investor has a right to dispose or RMB assets lawfully owned, verification and approval by the foreign exchange control authority is required.

### **Article 10**

When a foreign investor acquires the equity interest from shareholders of a Domestic Enterprise by agreement, and the Domestic Enterprise converts into an FIE, the registered capital of such FIE shall be that of the original Domestic Enterprise, and the foreign investor's percentage of capital contribution shall be that of the acquired equity interest in the registered capital of the Domestic Enterprise. When the acquired Domestic Enterprise increases its capital at the same time, the registered capital of the FIE after such acquisition shall be the sum of the registered capital of the Domestic Enterprise and the capital increase. The foreign investor and the previous investors of the Domestic Enterprise shall determine their respective percentage of contribution to the FIE's registered capital on the basis of asset evaluation on the Domestic Enterprise.

After the foreign investor subscribes to the capital increase of the Domestic Enterprise, and the Domestic Enterprise changes into an FIE, the registered capital of such FIE shall be the sum of the registered capital of the former Domestic Enterprise and the capital increase. The foreign investor and other investors of the former Domestic Enterprise shall determine their respective percentage of contribution to the FIE's registered capital on the basis of asset evaluation of the Domestic Enterprise.

Upon approval, individual Chinese shareholders of the Domestic Enterprise may continue to be the Chinese investors of the FIE established through M & A, provided that such individuals have been the shareholders of the Domestic Enterprise for more than a year.

### **Article 11**

When a foreign investor undertakes an Equity Acquisition, caps on the total investment amount of the FIE established through such acquisition shall be determined according to the following:

- (1) No more than ten sevenths of the registered capital, if the registered capital is below US\$2.1million;
- (2) No more than twice the registered capital, if the registered capital is more than US\$2.1million but no more than 5 million;
- (3) No more than 2.5 times the registered capital, if the registered capital is more than

US\$5 million but no more than 12million;

(4) No more than 3 times the registered capital, if the registered capital is over US\$12 million.

## **Article 12**

A foreign investor which undertakes an Equity Acquisition shall submit the following documents to the competent examination and approval authority determined in accordance with the total investment amount of the FIE to be established through such acquisition:

(1) The unanimous consent of the shareholders of the acquired Domestic Enterprise with regard to the acquisition, or the shareholders' resolution of the acquired Domestic Enterprise approving such acquisition;

(2) An application letter for converting the acquired Domestic Enterprise into an FIE in accordance with the law;

(3) The contract and the articles of association of the FIE established through such acquisition;

(4) The agreement regarding the foreign investor's purchase of equity interest from the shareholders of the acquired Domestic Enterprise, or the agreement regarding the foreign investor's contribution to the increased registered capital;

(5) The auditing reports of the acquired Domestic Enterprise for the most recent financial year;

(6) Identification papers, business licenses and credit standing certificates of the investors;

(7) Statements about the enterprises in which the acquired Domestic Enterprise has invested;

(8) Copies of the business licenses of the acquired Domestic Enterprise and the enterprises in which the acquired Domestic Enterprise has invested;

(9) The arrangement Plan for the employees of the acquired Domestic Enterprise;

(10) Documents required under Articles 7 and 19 of these rules.

If approvals from other relevant authorities, in respect of the business scope, scale, or land use rights of the FIE, are required, documents for such approvals shall be submitted together with the above.

The business scope of the enterprises invested by the acquired Domestic Enterprise shall be in compliance with, or otherwise adjusted to comply with the foreign investment industry policies.

**Article 13**

The equity purchase agreement and the agreement to increase the registered capital of the Domestic Enterprise specified under Article 12 hereunder shall be governed by Chinese laws, and shall include the following content:

- (1) The information about the parties to the agreements, including their names and domiciles, and the names, positions and nationalities of their legal representatives;
- (2) The amount and price for the equity purchased or for the capital increased;
- (3) The term and method of performance of such agreements;
- (4) Rights and obligations of each party;
- (5) Liabilities for breach, and dispute resolutions;
- (6) The date and place of such agreements.

**Article 14**

When a foreign investor undertakes an Asset Acquisition, the total investment amount of the contemplated FIE shall be determined on the basis of the transaction price of the Asset Acquisition and the actual scale of its production and operation. The registered capital of the FIE, and the percentage of such registered capital to the total investment amount shall comply with relevant provisions.

**Article 15**

A foreign investor which undertakes an Asset Acquisition shall submit the following documents to the competent examination and approval authority in accordance with the total investment amount of the contemplated FIE, the type of the enterprise and the type of industry, and in accordance with relevant laws, administrative regulations and department rules:

- (1) The resolution by owners of the Domestic Enterprise or competent authorities approving such asset sale;
- (2) An application letter for establishing the FIE;
- (3) The contract and articles of association of the contemplated FIE;
- (4) The asset purchase agreement between the contemplated FIE and the Domestic Enterprise, or the agreement between the foreign investor and the Domestic Enterprise;
- (5) Copies of the articles of association and business license of the acquired Domestic Enterprise;
- (6) Documents evidencing the notice and public announcement to the creditors of the

acquired Domestic Enterprise;

- (7) Identification papers, business licenses and credit standing certificates of the investors;
- (8) The arrangement plan for the employees of the acquired Domestic Enterprise;
- (9) Documents required under Articles 7 and 19 of these rules.

If permits from other relevant authorities, in respect of the asset purchase and operation specified in the preceding paragraph, are required, documents for such approvals shall be submitted together with the above.

If a foreign investor purchases by agreement the assets of a Domestic Enterprise, and uses such assets as investment to establish an FIE, the foreign investor shall not use such assets for any business purposes before the FIE is established.

#### **Article 16**

The asset purchase agreement specified under Article 15 hereunder shall be governed by Chinese laws, and shall include the following content:

- (1) A Description of the parties to the agreements, including their names and domiciles, and the names, positions and nationalities of their legal representatives;
- (2) A list of assets to be purchased, and the prices for the assets;
- (3) The term and method of performance of such agreements;
- (4) Rights and obligations of the parties;
- (5) Liabilities for breach, and dispute resolutions;
- (6) The date and place of such agreements.

#### **Article 17**

In case of an FIE established through M & A of Domestic Enterprises by foreign investors, the examination and approval authority shall make a decision of approval or disapproval in accordance with the law within 30 days after it receives all the required documents, unless otherwise specified under Article 20 hereunder. The examination and approval authority shall issue a certificate of approval if it approves the establishment of the FIE.

When a foreign investor purchases equity interest from shareholders of a Domestic Enterprise and the examination and approval authority approves of such purchase, the foreign investor shall send copies of such approval to the local authorities of foreign exchange where the Domestic Enterprise and the party transferring the equity interest are located. The local authority of foreign exchange where the transferring party is located shall complete the registration

formalities for the received foreign currency contribution, and issue a registration certificate for the contribution evidencing the payment by the foreign investor in such Equity Acquisition.

## **Article 18**

When a foreign investor undertakes an Asset Acquisition, the investors shall apply for a registration of the establishment of the FIE with the registration authority within 30 days after the receipt of the certificate of approval for the FIE, and obtain a business license for an FIE.

When a foreign investor undertakes an Equity Acquisition, the acquired Domestic Enterprise shall apply for an amendment registration with the original registration office in accordance with these Rules, and obtain a business license for an FIE. If the original registration office has no jurisdiction for such registration, it shall forward the application, together with the registration record of the acquired Domestic Enterprise, to a registration office with jurisdiction within 10 days after it receives such application. The acquired Domestic Enterprise, when applying for the amendment registration, shall submit the following documents and shall be responsible for their authenticity and validity:

- (1) An application letter for the amendment registration;
- (2) A shareholders' resolution of the acquired Domestic Enterprise, duly concluded in accordance with the Company Law of the People's Republic of China and the articles of association of the acquired Domestic Enterprise, approving the equity transfer or capital increase;
- (3) The agreement regarding the foreign investor's purchase of equity interest from the shareholders of the acquired Domestic Enterprise, or the agreement regarding the foreign investor's contribution to the increased registered capital;
- (4) The amended articles of association, or amendments to the articles of association, and the joint venture contract required by law;
- (5) The certificate of approval for the FIE;
- (6) Identification papers, business licenses and credit standing certificates of the foreign investor;
- (7) An updated list of board members, and documents recording the names and addresses of the new directors and their appointment letters;
- (8) Other relevant documents and certificates required by the SAIC.

When a State-owned equity interest is transferred, or when a foreign investor subscribes to the contribution to the increased registered capital of a company that comprises certain State-owned equity, approval documents from the authority in charge of economy and trade shall also be submitted.

Within 30 days after the receipt of the business license for an FIE, the investors shall complete

registration formalities with relevant authorities in charge of tax, customs, land administration, and foreign exchange, etc.

### **Article 19**

If any of the following is true of a foreign investor as to its M & A of a Domestic Enterprise, the investors shall report the same to MOFTEC and SAIC:

- (1) Either party to the M/A has revenues of over RMB1.5 billion from the Chinese market;
- (2) Merger or acquisition of more than 10 enterprises in related industries within a year;
- (3) Either party to the M/A has a share of no less than 20% of the Chinese market;
- (4) The M/A will result in a party occupying a share of no less than 25% of the Chinese market.

Even in cases where the above described circumstances do not exist, MOFTEC or SAIC may still request a report by the foreign investor, provided that it is so requested by the domestic competitors, relevant authorities or industrial associations, and deemed by MOFTEC or SAIC as to involve a big share of the market, or other factors affecting the market competition, national economy, public interest, or the economic security of our country.

A party to an M/A mentioned above includes any affiliate of the foreign investor.

### **Article 20**

When a foreign investor's M/A of a Domestic Enterprise falls under any of the items described under Article 19, and MOFTEC or SAIC decides that such activity may result in any over-concentrated investment which may be detrimental to fair competition and consumers' interests, a hearing participated by relevant departments, agencies, enterprises and other interested parties shall be held within 90 days after all required documents are received. Such hearing may be held by MOFTEC and SAIC jointly, or by either of them upon consultation with the other, after which a decision of approval or disapproval shall be made.

### **Article 21**

If any of the following is true of a foreign investor's M/A, the acquiring party shall submit its M/A plan to MOFTEC or SAIC before the public announcement of such plan, or simultaneously with its report of such plan to the relevant authorities of the foreign investor's home country. MOFTEC or SAIC shall make an investigation so as to decide whether the transaction contemplated by the plan will result in any over-concentrated investment, any detriment to fair competition and consumers' interest, and thereupon make a decision to approve or disapprove.

- (1) Any foreign party to the M & A has an asset of over RMB3 billion in China;

(2) Any foreign party to the M & A has a business proceeds of over RMB1.5 billion from the Chinese market in the current year;

(3) Any foreign party to the M & A, together with its affiliated companies, have had a share of no less than 20% of the Chinese market;

(4) The M & A may result in any foreign party, together with its affiliated companies, occupying a share of no less than 25% of the Chinese market;

(5) The M & A may result in any foreign party holding, directly or indirectly, equity interest in more than 15 FIEs in related domestic industries.

### **Article 22**

If an M & A fits any of the following descriptions, a party to the M & A may apply to MOFTEC and SAIC for an exemption from the investigation:

(1) The M & A will improve conditions for fair competition;

(2) The M & A will reorganize an enterprise that is being operated at a loss, and will help secure job opportunities;

(3) The M & A will introduce advanced technology and management talents, and help raise the competitiveness of the enterprise in the international market;

(4) The M & A will improve environment.

### **Article 23**

Documents submitted by the investors shall be sorted by categories in accordance with relevant provisions, and be attached by a document index. All the required documents shall be written in Chinese.

### **Article 24**

M & A of Domestic Enterprises by investment companies duly established by a foreign investor in China shall be governed by these Rules.

Equity Acquisition of an FIE by a foreign investor shall be governed by the existing laws and administrative regulations concerning FIEs, and the *Several Provisions Regarding Change of Shareholders' Equity Interests in Foreign Invested Enterprises*. If no provision of the above is relevant, these Rules shall apply.

### **Article 25**

M & A of Domestic Enterprises by investors from the Hong Kong Special Administrative Region, the Macao Special Administrative Region and Taiwan shall be regulated with reference to these Rules.

**Article 26**

These Rules shall take effect as of April 12, 2003.

*Promulgated on March 7, 2003 by the Ministry of Foreign Trade and Economic Cooperation, the State Administration of Taxation, the State Administration of Industry and Commerce and the State Administration of Foreign Exchange*

# Mergers & Acquisitions: Due Diligence in the People's Republic of China

ABA Section of International Law &  
Practice 2003 Spring Meeting

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# Due Diligence in China

- Defining Due Diligence:
  - Process of gathering and analyzing relevant information related to target and its assets/liabilities in pending transaction.
- Process:
  - Prepare requests for information/documents; evaluate responses and, if required, conduct an onsite evaluation
- Team:
  - Due diligence team should be made of legal team members, accountants/auditors, industry specialists, valuation experts, environmental experts, and purchaser and target representatives.

# Due Diligence in China

- Key Due Diligence Areas:
  - *Corporate Information and Records:*
    - Approval and Registration Documents: approval of target's feasibility study; certificates of approval/certificate of incorporation; business licenses and renewals; evidence of annual inspections; list of jurisdictions in which target operates; and any correspondence with any government entity related thereto.

# Due Diligence in China

- Key Due Diligence Areas:
  - *Corporate Information and Records, continued:*
    - Corporate Documents: original formation documents and all amendments thereto; minutes and all resolutions of all Board meetings and any Board committee; list of directors and officers including remuneration, benefits, awards, and appointment resolutions; copies of any agreements between director, officer or shareholder and target; all agreements related to share voting and transfer restrictions; list of option/warrant holders and information about option/warrant; all corporate governance policies; and all agreements related to target's capital and distributions.

# Due Diligence in China

- Key Due Diligence Areas:
  - *Corporate Information and Records, continued:*
    - Other Documents: capital verification report issued by auditor licensed in target's home jurisdiction; copies of shareholder's investment certificates; registration certificates (such as tax, customs, and foreign exchange); documents issued by target's bank; all documents related to any target branches, subsidiaries or affiliates; list of target's shareholders, including any shareholders' agreement; and all legal, financial, and business information related to any manufacturing, distribution, and supply networks used by target.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - ***Financial Information:***
    - Audited financial statements, including audited balance sheet, income statement, and cash flow statement; reconciliation of previous three (3) years' financial statements; details of accounting principles used in financial statements; details and support for allocations and assumptions used in financial statements.
    - Audited balance sheet for previous three (3) years, and a line-by line review of assets and liabilities; listing of assets as of the close of the previous calendar year and as of the transaction date; and information on capital expenditures, inventory, accounts receivable, accounts payable, cash balances, investment balances, prepaid expenses, deferred charges, accrued liabilities, pension and social insurance liabilities, and other personnel liabilities.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - ***Financial Information, continued:***
    - Audited income statement and pro-forma consolidated income statement (annual and monthly for previous three (3) years); pro-forma consolidated revenue, gross profit, and operating income; sales analysis; information on cost of goods.
  - ***Business Projections:***
    - Summaries of new market initiatives (new products or new advertising); information related to target's commitments for current and next year; and information related to assumptions made in next year's business, profit/loss, and sales projections.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - ***Assets and Land Use Rights:***
    - Information on target's tangible and intangible property as of later of end of previous calendar or fiscal year; appraisals related to same; all contracts related to sale, purchase or lease of target property, equipment or plant and tax certificates related thereto; certificates for real property and agreements related thereto; all information on security interests held in any of target's property; and any land use certificates and land use agreements.
  - ***Indebtedness:***
    - All loan agreements, working capital/letter of credit facilities, inventory financing agreements, mortgages, pledges, guarantees, financing leases or other indebtedness held directly or indirectly by target.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - ***Major Contracts:***
    - All “major” contracts over a certain monetary and/or time threshold; all technology agreements; all agreements with suppliers, manufacturers or customers; all warranties, indemnity or guarantee agreements executed by target; all agreements that could be terminated or materially altered by virtue of the transaction; and a summary of related party transactions.
  - ***Intellectual Property Rights:***
    - All information related to target’s intellectual property rights; all licenses, assignments, applications, registrations, and registration certificates related thereto; documents related to any of target’s software; and any information related to any security interest held in target’s intellectual property rights.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - *Insurance:*
    - copies of all insurance policies in force, details of any outstanding claims, and information on workers' compensation in relation to such insurance.
  - *Leases:*
    - all leases or other documents related to target's occupancy of its premises and Premises Registration Certificate related thereto.
  - *Distribution:*
    - investigation and evaluation of distribution network; agreements related thereto; identification of points of sale, price lists and sales terms, any commitments by target, and any product catalogues.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - *Taxes:*
    - documents related to any preferential tax treatment of target; tax reports for previous three (3) years; list of accrued tax liabilities; all correspondence and agreements with governmental entities regarding taxes; and all tax certificates.
  - *Legal Proceedings:*
    - all domestic or overseas administrative actions, arbitration, mediation, litigation against the target whether settled, pending or, to target's knowledge, threatened; any orders, injunctions, decrees, settlements, agreements, reports or notices related thereto.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - *Employment Issues:*
    - all employee contracts and agreements with any temporary staffing agency; personnel list specifying title, remuneration, job description, and related information; employee handbooks; information about outside consultants; past and pending employee disputes; documents describing benefits offered to employees; any agreements or documents related to trade unions; any information related to inspections related to employment, working conditions, social insurance, and health and safety; wage information for previous four (4) years.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - *Environmental Issues:*
    - internal regulations/policies related to environment/health/safety; copies of government certificates/permits related to environmental issues (such as air, noise, water, soil); all reports related to environmental inspections in previous three (3) years; past or pending citations, administrative proceedings, claims, consents, agreements or judgments related to target's environmental liabilities; all correspondence related to possible environmental exposures; history of leakage or spills and related remedial actions; agreements or commitments related to environmental liabilities...

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - *Environmental Issues, continued:*
    - ...records covering underground or aboveground storage tanks; records regarding discharge and disposal of hazardous wastes; records on current emissions within last three (3) years; contracts with contractors who transport, store, treat and dispose of wastewater; and details of chemicals used in the target's business.
  - *Industrial Information:*
    - layout of facilities; production capabilities; description of third party manufacturers (if any); information on key suppliers of past three (3) years; copies of all manufacturing licenses and authorizations; and breakdown of factory cost of goods.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - ***Logistics Issues:***
    - warehouse layout; storage capacity; analysis of logistics costs for previous three (3) years; and details of relationship with third party logistics provider (if any).
  - ***Information Technology:***
    - description of target's information technology infrastructure; list and description of all hardware and software; copies of all information technology contracts, such as licenses, service agreements, and leases.

# Due Diligence in China

- Key Due Diligence Areas, continued:
  - *Other Areas:*
    - copies of target's business plan for previous three (3) years; all local regulations and policies that materially affect the target; list of relevant government authorities regulating target; information related to local banks where target has taken out loans (if any); details of any special arrangements between target and local government authorities; copies of communications between the target and any administrative, regulatory or governmental authority; and any other “material” items.

# Due Diligence in China

- Benefits of Due Diligence:
  - Reveal potential liability issues
  - Reveal potential regulatory problems
  - Obtain better picture of the “value” to be transferred
  - Obtain better picture of limitations, performance and community/industry status of other party
  - Impacts drafting of representations/warranties and indemnity clauses, and allocation of transactional risk
  - Improves negotiating leverage and strategy
  - Better understand and plan for post-merger integration needs
  - Make deal more cost-effective and identify tax planning opportunities going forward

# Due Diligence in China

- Problem Areas in the PRC:
  - Publicly available records such as those maintained by SAIC, legal title to land use rights, existence of pending or threatened litigation, and security interests are unreliable or unavailable.
  - Chinese companies, especially SOEs, are used to rigid secrecy and are sometimes reluctant to provide data and records
  - Lack of data and records kept by target
  - Accounting is opaque and at odds with international standards
  - Legislation falling behind economic development?

# Due Diligence in China

- Some common due diligence discoveries in China:
  - business operations are beyond target's permissible business scope
  - land use rights have not been properly converted and are not transferable
  - no (or insufficient) legal title to assets
  - no documentation supporting book value of the assets
  - related party loans/transactions not documented properly
  - no employment contracts in place
  - intangible property--such as intellectual property rights--have not been properly registered with relevant authorities
  - foreign currency loans, payables or investment have not been properly registered
  - representative office license used for branch office operations

# Due Diligence in China

- Some common due diligence discoveries in China:
  - idle or underutilized assets not accounted for properly
  - unrecorded purchases, guarantees, commitments, and legal or semi-legal agreements
  - financial statements of poor or unreliable quality
  - trading results manipulated through related party transactions or other means
  - social welfare costs understated
  - business projections based on unsound assumptions
  - mandatory social welfare contributions not fully funded
  - transfer pricing policy is unsupportable
  - verbal agreements without legal basis made with tax authorities
  - tax compliance status is unclear