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Top Five Traps in M&A Transactions in China

Article By:

McDermott Will & Emery

As the second largest economy in the world, **China has become one of the top global markets for M&A transactions.** However, like many emerging markets, the **Chinese legal, regulatory and business environment is still in a state of flux,** and unwary foreign investors often fall prey to various traps in M&A transactions in China. In order to pursue and close a successful M&A deal in China, an investor must possess a thorough understanding of the local risks and challenges of Chinese characteristics, and wisdom and courage to come up with well-thought-out and creative solutions.

1. Regulatory Maze

Along with its rapid economic development, **China in recent years has quickly established multiple complicated layers of regulation on M&A activities**, which mainly include industry access review, antitrust review, national security review, tax and foreign exchange regulation, and supervision of the sale of state-owned assets.

An M&A transaction may be subject to the examination and approval of several different agencies and regulatory regimes, depending on the specific conditions of the target business to be acquired, *e.g.*, the industry sector and transaction type; whether the target business is encouraged, permitted or restricted for foreign investment; and whether the target business is state-owned, privately owned by foreign or Chinese entities, publicly traded or otherwise. If the target business is in key agricultural, infrastructure, defense, energy and resources, equipment manufacturing, technology or transportation services sectors, the M&A deal will trigger national security review by the Chinese government. Moreover, in the event the proposed M&A deal reaches the statutory threshold for antitrust review, the foreign investor must seek clearance from the antitrust authority in China before the deal can be closed.

The principal **government agencies responsible for reviewing and approving M&A deals include the Ministry of Commerce (MOFCOM); the State Administrations of Industry and Commerce (SAIC), of Foreign Exchange (SAFE) and of Taxation (SAT); the State-Owned Assets Supervision and Administration Commission (SASAC); and the China Securities Regulatory Commission (CSRC).** It is never an easy task for a foreign investor to navigate through red tape for a variety of approvals, and to make things worse, foreign investors often have to face the ambiguity of the law and the contradictory views and practices of different government agencies, which result from a combination of fast-changing and unclear laws and regulations and a lack of unified and detailed implementation rules.

Even though some M&A deals may be structured in such a way that the target business may be acquired outside China to minimize or avoid Chinese regulatory involvement, for most M&A deals, foreign investors and their counsel should be fully aware of the challenges in obtaining various regulatory approvals from the Chinese government, and should do sufficient homework to prepare and implement a sensible action plan.

2. Hidden Liabilities

Hidden or contingent liabilities associated with previous operations of the acquired business are a key area of concern in most M&A transactions. Such legacy liabilities may arise from a wide variety of sources in China, including but not limited to unpaid tax, insufficient social welfare payments, undocumented guarantees, non-compliant transfer pricing arrangements, product liabilities, customs violations, environmental liabilities and other regulatory violations.

To identify such legacy liabilities and protect the acquired business from them, foreign investors must conduct due diligence on the operational and financial conditions of the target business. As the publicly available information and government records about the target businesses in China are often either inadequate or unreliable, the foreign investors will have to conduct their due diligence mainly based on the information disclosed by the target business.

Unfortunately, as in many emerging markets, **foreign investors are often dismayed by the lack of developed accounting standards and the low compliance levels in accounting and disclosure obligations in China.** For example, **it is not uncommon for a family-controlled or owner-managed business in China to utilize various means to reduce tax that may contravene tax regulations, or to overstate the revenues for a better sale price, which may constitute commercial fraud**. The recent scandals of Chinese companies listed in New York, Hong Kong and Toronto are just the tip of the iceberg of such risks.

There is no single magic procedure guaranteeing that all hidden liabilities and potential exposures will be identified. Savvy foreign investors should select experienced advisors (including a private investigator if necessary) who have the local knowledge and skill to identify the hidden issues at an early stage.

3. The Real Control of the Acquired Business

Foreign investors who acquire all or a majority of the equity interest in a target company often assume that they will have real control of the acquired business, but the painful fact is that **control by equity is never guaranteed in China.**

According to Chinese company law, every Chinese company will have a legal representative, who will be the chairman of the board of directors or the general manager of the company. While the legal representative may sometimes be held liable for various administrative and criminal liabilities of a company, the legal representative is also granted by Chinese law to have automatic power to act for the company. In other words, any important legal documents or court proceedings of a company must be signed by a legal representative, and more importantly, any contracts once signed by the legal representative will become binding on the company unless the other side knew or should have known such signature exceeded the power granted to the legal representative by the company. As foreign investors are often reluctant to take the position of legal representative for fear of the possible personal liabilities, the above statutory powers will often be given to the representative of the local Chinese partner or the original local Chinese management staff.

Additionally, every **Chinese company will have a set of corporate seals, including a general seal, a financial seal and a contract seal.** Like the signature of the legal representative, a stamp of these seals, particularly the general seal, will also make a legal document automatically binding on the company. As these seals are generally kept by local senior management to facilitate the daily operational activities of the company, the offshore shareholders may be kept in the dark when the company runs into trouble because of improper use of such seals.

4. Dealing with State-Owned Companies

Acquiring a state-owned business in China is subject to a more complex regulatory regime. To prevent the loss of state-owned assets, Chinese law mandates that any sale of state-owned assets shall be valued by authorized appraisers, and the sale of such assets can only be concluded following the public announcement, listing and opening bidding process in the Chinese assets exchanges. If the proposed M&A deal consists of a management buyout restructuring, a stricter procedure for the approval and public bidding will apply. Any deviation or violation of these procedures may entitle the state-owned assets supervision authority to challenge the validity of such transaction by legal proceedings, which, in the worst scenario, may even lead to criminal proceedings.

Because the most commonly used asset valuation methods for state-owned assets often produce inflated valuations, resulting in such statutory valuations not reflecting the true economic value of the business, the foreign investor would still need to perform its own valuation of the business to establish the price range which it is willing to pay for the target business. If there exists a significant discrepancy between the foreign investor’s valuation and the above statutory valuation, it may be difficult to close the deal within the mutually acceptable price range, as the official appraiser’s valuation will serve as the bottom price for such transaction during the public announcement and bidding process.

It is often difficult to understand the true quality of earnings of state-owned enterprises, as they generally have extensive direct or indirect interests in other business entities with whom they transact. Such related party transactions are often conducted on non-arms-length terms, and there can be significant alterations to the financial conditions of the target business once these related party transactions are either excluded or restated per fair market value.

Foreign investors should also be particularly aware of employment issues related to target state-owned businesses with significant labor redundancy. Because major layoffs might trigger worker protests and other social unrest, the whole transaction may be jeopardized if such labor issues cannot be properly settled. It should also be pointed out that given the various protections granted by Chinese labor laws to the employees, it will generally be very costly for foreign investors to settle such labor matters on their own.

5. The Legality of VIE Structure

Foreign investors often use variable interest entities (VIEs) to gain access to sectors of China’s economy (such as telecommunications and media) that restrict or even prohibit

foreign investment. VIEs have been widely used in the corporate structures of many “Chinese” ventures, particularly those in the telecommunications and media sectors, including internet services, online games, value-added services, radio, film and publications. Typically, these VIEs are owned by Chinese citizens and hold licenses, intellectual property, assets and so on, and they are controlled via contractual arrangements by a wholly owned foreign subsidiary (WOFE) in China owned by the foreign investor.

Although the Chinese government has not officially raised any objections to many companies using VIE structures to operate restricted businesses in China when they list in Hong Kong or the United States, the true purpose of such VIE structures is no doubt to circumvent the mandatory restrictions under the Chinese foreign investment laws, which alone shall sufficiently render such structure and the underlying contracts invalid under the Chinese laws. In addition, certain Chinese government agencies have already issued regulatory circulars to prohibit using VIE structures to run certain businesses, such as online games, in China.

Another major inherent risk of the VIE structure is the transfer-pricing issue, as the profits of the VIEs need to be controlled and moved up to the WOFEs established by the offshore entities in the name of management service fee, equipment lease, IP license royalties, etc. As the Chinese tax authority is tightening up its scrutiny on transfer-pricing activities, the reasonableness of the prices of various controlling contracts under the VIE structure may become a target.

Conclusions

These are just a few of the potential pitfalls foreign investors may encounter in their M&A transactions in China. Savvy foreign investors should deal with such challenges in an informed, flexible and creative manner, as, according to a Chinese saying, the big challenges always co-exist with big opportunities.

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