



## **Due diligence for joint ventures, mergers and acquisitions in China**

*There are many ways to enter the Chinese market, including the establishment of a representative office, outsourcing production, founding a new company or setting up a production site. An often overlooked way for small and medium-sized enterprises (SMEs) to establish or expand their business in China is through investment in an existing Chinese company. The term investment is used here in a broad sense, including cooperation with a Chinese partner – in either a cooperative joint venture (CJV) or an equity joint venture (EJV) –, as well as the acquisition of a Chinese company in the form of a merger or acquisition (M&A).*

*Since 1993, China has had one of the highest growth rates of foreign investment in the world. However, not all investments have brought the success the investors were looking for. Only those equipped with sufficient knowledge of the market, a keen business sense and a drop of luck can expect to be successful in China.*

*Although developing quickly, the M&A market in China is not yet comparable to established western markets. Because of this, it is extremely important to estimate risks carefully and prepare every step with the necessary due diligence. However, because of the many cultural and structural differences in the Chinese business environment, the process that needs to be employed to realistically assess the risks of cooperating with a Chinese partner differs markedly from the standard procedures used in many western countries. This guideline will point out these fundamental differences and outline ways to cope with them, ultimately helping SMEs to make informed decisions and identify the risks involved.*

## Table of Content

1	Significance of JVs and M&As for businesses coming to China .....	1
2	Due diligence in different transaction structures .....	1
2.1	Joint ventures .....	2
2.2	Mergers & acquisitions .....	3
3	Purpose and functions of comprehensive due diligence .....	3
3.1	Goals of due diligence and their impact on the scope of the process.....	4
4	Preconditions for effective and successful due diligence .....	7
4.1	Successful due diligence does not necessarily result in a deal.....	7
4.2	Understanding cultural differences .....	7
4.2.1	Preserving ‘face’ .....	7
4.2.2	Bridging the gap.....	8
4.2.3	Building a relationship .....	8
4.2.4	Supplementing and backing up information .....	8
4.3	The due diligence team .....	9
4.4	How to ensure good cooperation with the target company.....	9
5	Execution of the due diligence process.....	10
5.1	Procedure .....	11
5.1.1	Introduction and the due diligence list.....	11
5.1.2	First contact.....	12
5.1.3	Physical checks and verification at the target .....	12
5.1.4	Involving government authorities and third parties .....	12
5.1.5	Final stages.....	13
5.2	The due diligence list.....	13
6	Scope of due diligence in China .....	15
6.1	Establishment of the target company .....	15
6.2	Corporate structure of the target company.....	16
6.3	Main assets.....	17
6.3.1	Land use rights and buildings .....	18
6.3.2	Intellectual property (rights) .....	19
6.4	Other assets .....	20

6.5	Material contracts.....	20
6.6	Labour contracts and social insurance .....	21
6.7	Commercial and financial due diligence.....	23
6.8	Taxation and customs .....	24
6.9	Other issues.....	24
6.9.1	Product liability.....	24
6.9.2	Bribery and corruption .....	25
6.9.3	Environmental issues .....	25
6.9.4	Antitrust .....	26
6.9.5	Litigation and arbitration .....	26
7	Formalities and document verification .....	26
8	Particular problems with state-owned enterprises and problems particular to China .....	27
9	Case study .....	28

Due diligence is often perceived as a costly and long process which is appropriate for large enterprises and huge investments only. This is not the case. If a company follows the step-by-step approach proposed in this guideline, the process can be tailored to the specific needs of the investing party and the particularities of the investment target. The goal is to enable SMEs with limited resources to conduct effective and meaningful due diligence to protect their business in China.

## 1 Significance of JVs and M&As for businesses coming to China

China is a major recipient of foreign investment. Prior to 2009, yearly double-digit growth in foreign direct investment (FDI)<sup>1</sup> was the norm. Inflow declined slightly in 2009 because of reduced inbound M&A and fewer investments by foreign companies, but substantial growth returned in 2010.

The Chinese government is focused on attracting more foreign investors through further easing of M&A restrictions and improvements to the investment landscape in selected sectors, such as high-tech and environmental protection. Meanwhile, industry sectors most favoured by foreign investors include consumer products, information and communication technology (ICT), energy, as well as professional and financial services<sup>2</sup>.

In the past, many companies favoured their own greenfield operations in China, which allows for full control over all business aspects but entails sustained and costly efforts to build up the necessary infrastructure in terms of supply and distribution networks as well as customer base. Today, a partnership with a reliable Chinese company operating on a proven business model and with the necessary networks already in place may be a viable alternative, especially for SMEs lacking the expertise, experience and relationships necessary to get a foothold in this huge market. Hence, M&A deals are often seen as a quick, if not always a cheap alternative to the establishment of a whole new business infrastructure. M&As are also becoming increasingly popular as a tool to quickly conquer new markets, gain greater market shares, enhance operational efficiency and improve competitiveness and returns.

As a result, M&A is playing an increasing role not only for the big players but also and especially for small and medium-sized enterprises. Since many of these companies have relatively little experience with these kinds of deals, SMEs need to catch up fast and get familiar with the due diligence process, as it constitutes a major part of any such transaction.

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## 2 Due diligence in different transaction structures

Any company may make use of the products, services, resources, even ideas or any other asset another company may offer, in many different ways. It can decide to buy such services, products or assets, which would constitute trade. The two companies can work together towards a commonly defined goal while keeping their separate identities, which would constitute cooperation or a strategic partnership. Or it can join with one or more partners to establish a third entity, a joint venture or

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<sup>1</sup> Source: United Nations Conference on Trade and Development (UNCTAD) and statistics of Ministry of Commerce of the People's Republic of China (<http://english.mofcom.gov.cn/article/statistic/foreigninvestment/>)

<sup>2</sup> Source: PwC 'China deals: A wind of change for China-Europe M&A' (<http://www.pwcblogs.be/transactions/wp-content/uploads/2013/04/china-deals-a-wind-of-change.pdf>)

decide to go together in one way or another to jointly become one entity, which would constitute M&A. Whatever they do, they will enter into a relationship.

Whoever invests into a business relationship, be it trade, cooperation or working together as one entity like in M&A situations, takes the risk of not (or not entirely) getting what he expects or hopes to get out of this relationship.

**Due diligence** in connection with an investment transaction is the procedure in which the investor analyses and evaluates the risks connected with such transaction by investigating the target.

To minimise these risks is the goal of due diligence, which is achieved by scrutinising the target company from all angles to find out whether the other party is suitable for this kind of relationship and whether it is likely to be able to keep its part of the deal. After this investigation and the analysis of the results any investor will have sufficient data to determine if the proposed relationship is viable and what it will take to turn it into a sustainable business partnership.

In any due diligence process the investing party will assess the abilities, trust- and creditworthiness of the other party as well as the quality of its products or services. The higher the investment and the more valuable the issues at stake, the more intensive the investigation will have to be.

The general process of due diligence and its principles are the same for all business relationships. However, the process varies widely in intensity and content according to the type of business relationship or transaction in question. As formal due diligence is most commonly used for joint ventures, mergers and acquisitions, this report focuses on these three types of transactions.

## 2.1 Joint ventures

Joint ventures denote the creation of a new business while participating parties continue to operate their original companies separately. In China, joint ventures can be formed either as equity joint ventures (EJV) and cooperative joint ventures (CJV). In an EJV both parties invest into the equity of a new entity and thus become equity partners. In a CJV the new business is formed by contractual cooperation but without forming a new company. In many foreign-Chinese joint ventures the foreign party contributes money and technology while the Chinese party typically contributes access to the market, supply chains and distribution channels. However, this model may change as Chinese industries are maturing quickly.

Cooperation in joint ventures can be characterised as less intensive compared to mergers or acquisitions, in the process of which one entity is incorporated into another company. JVs are also gauged to be less risky, as any internal problem of the other party – be it taxes or any permits for their business – does not directly affect the economic well-being of the JV or the other party. The specific risk in any joint venture lies in the uncertainty of whether both parties are able to make the respective contributions as promised in the joint venture agreement. Therefore, any due diligence in preparation for a JV has to focus on, and is usually limited to, such issues. As contributions can be in money or in kind, **due diligence has to check the reliability and creditworthiness of the other party as well as the ability to make the agreed contributions on time.** As the kind of contribution can vary, it is not possible to set up a system which is appropriate for all JVs. Only in large cases will the whole

procedure described in this report be put to action and companies are advised to adjust the elements to their specific needs. In any case, the main tools for controlling the risk in joint venture transactions are carefully formulated contract clauses like condition precedents, which render the agreement invalid unless certain conditions are met, warranties, which contain a guarantee or promise with defined consequences if such guarantees are not fulfilled, or representations, i.e. statements of fact directed at the other party, which in case they prove to be false may lead to legal consequences.

## 2.2 Mergers & acquisitions

The term mergers and acquisitions (M&A) is used for a variety of business transactions dealing with the purchase, sale, division and combination of different companies. In fact, from a legal point of view, mergers on the one hand and acquisitions on the other hand are two different types of transactions.

**Merger** is a transaction in which the investor and the target fuse (merge) into one new entity while investor and target cease to exist as separate entities.

**Acquisition** is a transaction in which the buyer acquires the whole target entity or any number of its shares, while both entities continue to exist but with a change in ownership with regards to the target.

Merger means the fusion of two separate companies into one with the result that neither of the merging parties continues to exist. Instead, a new entity is established which contains all the assets of both parties.

In an acquisition the target company continues to exist but is owned or controlled by the acquirer.

Legally, the distinction is of significance as in China a different set of rules may apply to the one or the other. Regarding due diligence, however, it is of no major significance. The acquiring company as well as the company resulting from a merger will both be responsible for the assets and operations of the target company. So it is equally important for both sides to perform thorough risk assessment through a due diligence process. As a consequence, all aspects of this report are equally important for both mergers and acquisitions. Distinctions can only be made depending on the specific target or specific deal structure.

## 3 Purpose and functions of comprehensive due diligence

Due diligence procedures can be time-consuming and expensive, especially for SMEs.

A 2006 study by Ernst & Young mentions that only 20% - 30% of all letters of intent signed prior to the due diligence stage in China progress into a signed contract. Internationally, the success rate is as high as 70%. This may be seen as an indicator of the seriousness of the problems encountered during an investigation into the background of potential business partners. The Chinese market – just like other developing markets – still lacks transparency, which makes thorough due diligence more difficult, but also more important than in the West. Only after collecting the relevant data will you be

able to make a sound decision concerning the quality of the transaction and whether or not to commit to a proposed partnership.

To further understand the necessity of due diligence and to keep the whole process as short as possible as well as thorough as necessary, it is important to take a closer look at the major goals of due diligence while taking into account the particularities of the Chinese market.

### 3.1 Goals of due diligence and their impact on the scope of the process

Due diligence for the acquisition of the majority of shares of a large enterprise will look very different from one for the establishment of a contractual joint venture between two smaller companies.

The main purpose of every due diligence effort is to protect the investment by identifying risks connected with a particular transaction.

Due diligence procedures can differ widely in scope, depth and focus. Every kind of transaction has its own particular risks. Different deal structures can bear different risks and therefore call for different aspects of due diligence. For instance, an investment project can be realised by buying the shares of the target company ('share deal') and thus becoming the owner of the company which owns the desired assets. As the investor now integrates the target company into his own company structure, he needs to check for any risks hidden in the corporate setup of the target. However, one could also buy the desired assets (like land use rights, machinery etc.) directly without taking over the ownership of the company ('asset deal'). In an asset deal, the buyer does not need to worry about any risks connected with the corporate setup of the target company and due diligence can therefore be limited to the investigation of the assets. Efficient due diligence should always specifically address the risks connected with the chosen transaction structure and not concern itself with matters that will be of no consequence in the future.

In many cases, however, the choice of the transaction structure itself depends to some extent on the investment target and its particular risk structure, i.e., the results of the due diligence process. While the discovery of major compliance issues might be a 'no-go signal' for a share deal, an asset deal might still be desirable in many cases.

Therefore, a two-step approach to any due diligence is suggested:

1. **Basic due diligence** procedures should be considered very early in any transaction to enable the investor to make a decision on the most suitable transaction strategy.
2. After the transaction structure has been chosen it is easier to determine which aspects the second phase – **the detailed investigation** – needs to focus on.

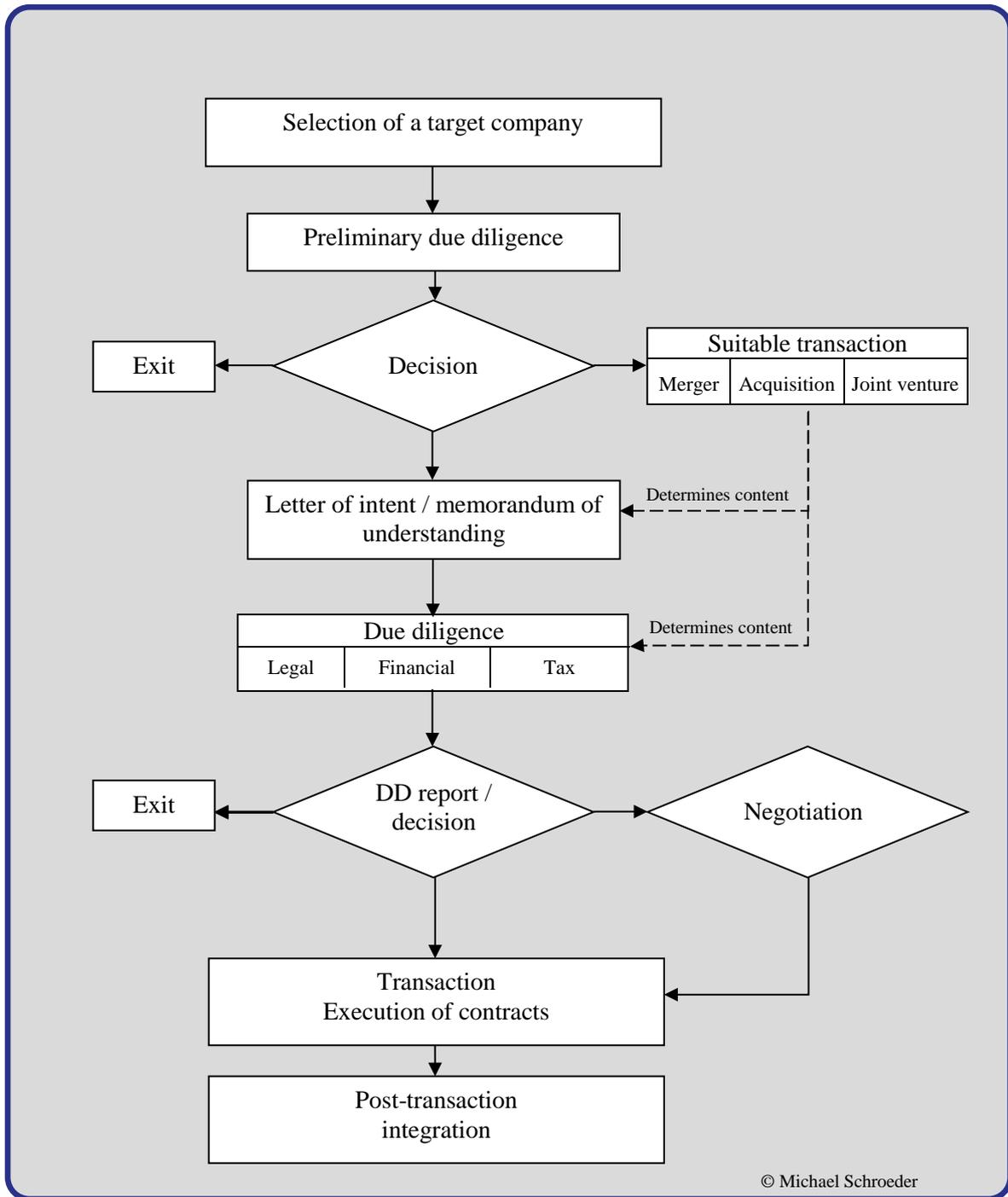
In addition to securing the assets of the investor, conducting due diligence will also help to prepare for a smooth post-transaction operation. This is especially helpful in China, where dealing with post-M&A issues can be much more complex than in your home country.

At the end of every due diligence procedure, if conducted right, the investigating party possesses a comprehensive and structured collection of data in the form of a due diligence report which:

- 1) Provides the investor with the ability to respond to certain risks:
  - a) by adjusting the price;

- b) by re-delegating the risk to the potential partner or seller through contractual arrangements (representations and warranties);
  - c) by delegating potential risks to external advisors;
  - d) by implementing conditions precedent to closing, such as oblige the target company to resolve certain issues before conclusion of the transaction ('clean-up' exercise);
  - e) by requiring additional evidence of compliance, such as compliance certificates issued by the relevant authorities;
  - f) by walking away from the transaction (if the risks outweigh the prospected benefits);
- 2) Provides useful information for further negotiations;
- 3) Is in many cases very useful for the future operation of the target enterprise or JV. It can be used to facilitate the post-transaction integration and transition and is particularly helpful when transparency is an issue and the parties additionally have to deal with language and cultural issues.

The following chart provides a rough overview of the function of due diligence in a transaction context when applying the proposed two-step approach.



## 4 Preconditions for effective and successful due diligence

Before turning to the execution and content of the due diligence process, it is important to have a quick look at the factors which make due diligence successful.

### 4.1 Successful due diligence does not necessarily result in a deal

The success of due diligence needs to be viewed separately from the successful closing of a deal. Sometimes, a failed deal is the result of successful due diligence, i.e., in cases where due diligence revealed hidden risks or flaws of the target company which might not only have put the transaction project itself but also the investing party at risk of losing business or money. Thus, if the process results in a clear picture of the risks involved and the investor is able to react and change its strategy accordingly, the due diligence process was successful.

On the other hand, an expensive report that does not reveal the risks hidden in the target is clear evidence of unsuccessful due diligence. Therefore, the success of any due diligence can be determined by correlating the quantity and quality of the data collected with the resources spent to acquire them.

### 4.2 Understanding cultural differences

Despite globalisation and internationalisation, there are still a number of cultural differences between China and the western world. From the perspective of an investor (irrespective of the size of the investment), the different approach to how business is done and people are treated, how difficulties are handled and communication with shareholders, stakeholders, interested parties or the public is conducted will be noticeable from the start. As due diligence has a lot to do with the art of communication, these differences have to be taken seriously to make successful cooperation possible.

As the free market economy is still in development in China, it is not surprising that some Chinese companies still lack experience with the due diligence process and feel uncomfortable about revealing internal information to potential competitors. The same is true for advisers and sometimes even law firms. Only by addressing these concerns and underscoring the importance of this process will you be able to get the results necessary for a realistic assessment of the circumstances.

#### 4.2.1 Preserving 'face'

Even though traditional Chinese lifestyles and mannerisms are becoming less common in a society that has become accustomed to constant change, preserving 'face' is still very important to the majority of the population – just like proper etiquette is still required in many parts of the western business world. This explains why the Chinese party often perceives the notion of full disclosure during the due diligence process as an expression of unjust suspicion on the part of the foreign partner. In many cases the Chinese counterpart will be reluctant to disclose information to outsiders, particularly to foreign parties. The assumption that it might be advantageous and acceptable to hold back on related data appears to prevail at least outside major business centres like Beijing or Shanghai.

It is therefore extremely helpful to have someone in the team who is able to explain the underlying reasons to the business executives of the Chinese party and help them focus on the larger goals of the deal instead of fighting over every figure. Your partner needs to understand that you are willing and able to walk away from any deal at any time if you cannot get a reliable picture of the real situation of the target company based on trustworthy data.

To keep all information confidential and to assure your partner of this by signing a binding confidentiality agreement will go a long way towards convincing your partner that he will not lose face, whatever the result of the due diligence procedure might be.

#### 4.2.2 Bridging the gap

Chinese companies, large state-owned enterprises as well as small and medium-sized private enterprises, might not be familiar with common international practices. It might therefore be helpful to suggest to the Chinese party to engage the China office of an international law firm or a local counsel with international experience as their advisor during the due diligence process. It might seem like acting against your own interests to suggest a strong and knowledgeable legal counsel at the opposite end of the table, but this will likely save you a lot of time and energy as it will help your 'opponent' focus on the material issues and get comfortable with international practices. However, be careful not to put too much hope on the legal counsel, as trusting a lawyer on significant issues is not yet common practice in all Chinese enterprises.

#### 4.2.3 Building a relationship

Your main task will be to gain the trust and comfort of the main decision makers in your target company. China's business culture is still based to a large part on personal relationships. To receive the information you need and later close the deal you are aiming at, it is crucial to appreciate the need to establish and nurture a cordial, dignified relationship with your partner. The Chinese party might be under pressure not to appear to 'surrender' to foreigners and lose face in the process, especially if any disclosure of information might weaken their bargaining position. Therefore, you need to be prepared to accept information received in an informal way rather than forcing your Chinese partner to officially disclose certain information to you. After all, all you need for successful due diligence is the information itself, irrespective of the channels through which you received it (for as long as it is legally obtained).

A good and cordial relationship may also help to overcome problems which arise because the Chinese target enterprise is in fact willing to cooperate, but particular sets of information or documents may simply not be available due to a lack of proper book-keeping and compliance with PRC laws. In this situation, a trustful relationship could help to work out a way to get the necessary information even without the precise data instead of walking away from the deal right away.

#### 4.2.4 Supplementing and backing up information

Building a good and trustful relationship is a good start, but not enough to get the results needed for thorough risk assessment. Even if the management of the target company is familiar with international practices and you have established a good relationship with the main decision makers, the information you receive might not always be accurate. There are many reasons why the seller of a company might want to tweak the numbers and hide certain facts when audited by an outsider.

Because of this, due diligence in China should not only rely on the data provided by the seller of a target enterprise or the target enterprise itself. Instead, any such information should be supplemented and verified through other sources where available. Sources for such supplementary information might be independent company search agencies located in China or Hong Kong, which in many cases can gather surprisingly accurate data. In addition, information obtained from other sources like

embassies, business associations or local contacts should be used to complete the picture of the target company.

However, no matter how urgent the need for supplementary information on a target enterprise might be, the use of illegal practices to gather information should be avoided by all means, as such engagement might result in severe legal consequences for everybody involved.

#### 4.3 The due diligence team

To find one person who is an excellent accountant and at the same time knows the laws and regulations in all industries in all localities in China is almost impossible. Therefore, your due diligence efforts need to be handled by a knowledgeable and experienced team.

To assemble the right team for China, any foreign investor has to take into account some country-specific characteristics. Below, you will find some considerations which will also be useful for any other negotiation with Chinese enterprises.

Make sure to have someone on board who understands M&A practices and structures in China, as they might differ slightly from other countries due to specific regulations in different industries. This may be your legal adviser who is specialised in M&A deals or a special M&A adviser who understands both Chinese and foreign business culture (including regional nuances).

The accountant should also be familiar with both Chinese and foreign accounting practices, as they may differ widely. In many cases, accounting has to be transformed from the Chinese to a foreign system or international standard to be able to extract certain key information. For medium-sized transactions, one of the 'Big 4' public accounting firms (PwC, Deloitte, Ernst & Young, KPMG) is usually engaged. However, this is not necessary if the budget for the transaction is limited, especially for rather small transactions. For these cases, there are various smaller to mid-market advisers with growing capacities in due diligence procedures. The website of the EU SME Centre features a database of service providers including law firms, accounting and tax advisors that will be helpful in assembling your due diligence team.

In more difficult cases, you may also want to consider hiring private investigators. As described before, total disclosure of all relevant facts by the Chinese party cannot yet be taken for granted. The services of a reputable private investigator might be very useful in cases where a listed company is concerned about compliance or has to follow a certain corporate governance code. In such cases, discrete in-depth investigation can help reveal issues and formulate a compliance strategy. Knowing the personal history and background of key shareholders of the target enterprise is also an important part of overall risk management, especially in the case of owner-managed targets.

#### 4.4 How to ensure good cooperation with the target company

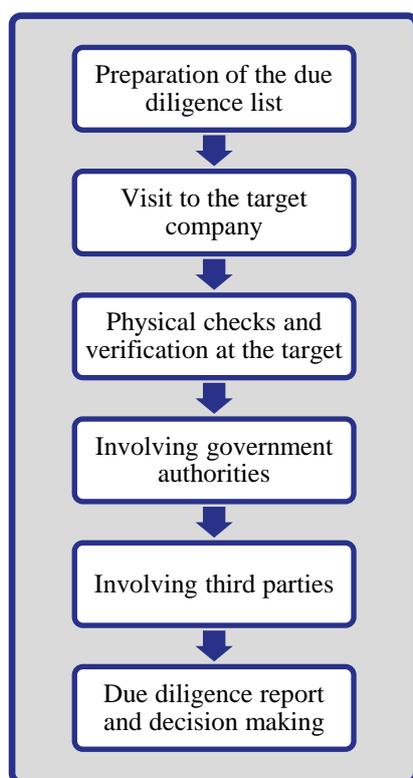
The following tips may help any foreign investor to avoid hard feelings and steer clear of any misunderstandings in order to make due diligence process as smooth as possible:

- Explain the due diligence process to the Chinese target's senior management as early as possible.
- Ensure the active participation and cooperation of your target by letting them understand that successful due diligence is key to a successful transaction.
- Have them understand that you are prepared to walk away from the deal if due diligence cannot be conducted successfully. Explain that thorough due diligence might help solve problems. Issues that come up during a due diligence audit may be resolved on a mutual basis while existing issues that come up later might end any further negotiation.
- Provide any due diligence questionnaire in Chinese to avoid any 'escape to language barriers'.
- Make sure that you have the necessary language skills on your team. Do not rely on translations supplied by either your target or a random translation agency. At least one senior member of your due diligence team should be at least bilingual (Chinese/English plus your home language if possible), since you cannot assume that your counterparts, especially from the senior management of your target enterprise, will speak and understand English very well. Poor translation support may cause serious problems as even a correct literal translation does not always transport the intended nuances. It should be ensured that the parties have a chance to really meet, not only on deal terms, but also on technical legal concepts. This is where a skilful, bilingual legal counsel can become really valuable. Language and intercultural skills can also help in situations where the Chinese party expresses agreement, but merely as a matter of face, while not yet having understood the legal significance of a certain concept.

## 5 Execution of the due diligence process

Especially if you have not yet decided on just one potential target or one definite M&A structure, it may be useful to approach due diligence in two steps, as suggested earlier (see 3.1). By conducting preliminary due diligence and checking only those issues that will determine your choice of M&A structure first, it will become easier to tailor the rest of the process exactly to your needs and make it as slim and efficient as possible. Ideally, a letter of intent (LoI) is drafted at the end of the preliminary due diligence; this will help specify the way of future cooperation more clearly.

## 5.1 Procedure



There is no set way in which due diligence has to be organised. Anything within the borders of the law that helps unearth the information necessary is possible. Although not recommended for use in China, some due diligence exercises are limited to the access to a virtual data room, where the investigating party can log in and check the documents provided on a special server of the target company. Others involve a lock-in in a physical data room, where the relevant documents are being made available for a certain period of time. Many ways are conceivable, as long as both parties are comfortable with it. Frequent visits to the premises of the potential partner and direct access to its key departments will often prove to be the most efficient way forward in China. The following guidelines will help the user to conduct due diligence in a way that is widely accepted on the M&A market in China and which pays attention to the particularities of the Chinese market and intercultural aspects. It goes without saying that this should not be seen as a fixed, rigid structure, it should be handled flexibly and adjusted wherever possible to the specific needs of the transaction and particularities of the parties involved. The chart above shows a model due diligence procedure which will be explained below.

### 5.1.1 Introduction and the due diligence list

- 1) According to the details of the intended transaction, the character of the target company and the industry in which the target company is operating, a due diligence list (checklist) needs to be drafted by a legal advisor and an accountant (financial consultant). This list is the heart of the due diligence process and should therefore be prepared carefully. Items that are not on the list might be overlooked in the later stages of the process and might lead to potential risks. It has to contain every single aspect which needs to be clarified and point out the respective documents necessary as proof. An outline of the most common issues of special concern for M&A projects in China can be found below (see 5.2). However, the particular items can only be determined on the basis of the facts of a given case.
- 2) When the due diligence list is ready, the investor should appoint a designated person to serve as a contact point during the due diligence procedure and assist with the organisational execution of the process. The name of this person and his or her contact details should be mentioned on the due diligence list and any other request for information addressed to the target company. It is also advisable to include a deadline or a reasonable timeframe for the completion of the reply to avoid unnecessary delay. Any request for additional time by the Chinese counterpart might provide insight into the availability of the requested data.

### 5.1.2 First contact

- 1) The due diligence list has to be delivered to the target company.
- 2) Representatives of the investor should visit the target company after sending the due diligence list and organise a special meeting with all personnel of the target company involved in the process. The main purpose of this meeting is to go through the due diligence list together and explain its content and the requirements of legal, financial and tax due diligence to the target company. The meeting should give the representatives of the target company the chance to raise questions and concerns regarding all aspects of the process, which should be answered openly. It can also be used to discuss and determine the timeframe for the first reply. It is advisable to keep such a meeting on a working level. Make sure that the delegation of the investor consists of those who know the due diligence list best and are familiar with questions that might be brought up during the meeting. To keep this meeting on a working level also helps the senior management of the target to 'keep face' in case the meeting does not go as smoothly as planned. Ceremonial procedure can be reduced to a minimum, which saves time and helps to focus on the main targets. The signing of the letter of intent or the completion of the due diligence report are more appropriate times for ceremony and a meeting of the senior management of both partners.
- 3) After compiling the documentation requested in the due diligence list, the target company needs to send the collected documents (ideally in one lot) together with the answered and commented due diligence list to the designated contact person, who will then distribute the different parts (legal, finance, tax etc.) to the respective specialists of the due diligence team. In case the documents are too large in number or where it is not appropriate or convenient to send them, the target company may also send a list of the prepared documents with the request to check them in a data room, set up for that occasion.

### 5.1.3 Physical checks and verification at the target

- 1) The legal and financial advisers may then visit the target company for a second time to collect materials which have been omitted by the target or which were not finished in time. Auditors may conduct necessary physical checks to verify certain issues. It is advisable to request the respective personnel of the Chinese counterpart to be available for this visit, as management sometimes relies heavily on them to find the necessary documents.
- 2) Most commonly, a meeting with the investors and the legal, financial and tax advisers will be held with representatives of the target company to check and confirm the most crucial issues and to gather further explanations from the target company.
- 3) Depending on the outcome of the meetings and the satisfaction with the explanations given, some documents might need to be checked for authenticity and validity. **It would be negligent to simply take the authenticity or validity of all documents presented by the target for granted.**

### 5.1.4 Involving government authorities and third parties

As mentioned earlier (see 4.2.4), the most significant documents and crucial issues should, in all cases, be verified using means and sources other than the target company.

- 1) Visit relevant government authorities for checks and confirmation where necessary;

- 2) Send confirmation requests to creditors and debtors, where necessary and appropriate.

#### 5.1.5 Final stages

All gathered information and confirmation thereof must be analysed and evaluated to gauge the specific risks in relation to the intended investment structure.

- 1) The result of the due diligence process should be summarised in a **due diligence report**, which should be distributed among the senior management of the investor and the negotiation team.
- 2) Legal, financial and tax advisors should meet with the investor (strategists, senior management, regional manager etc.) to elaborate on certain significant issues and, where possible, provide solutions. Solutions may consist of:
  - a) adding certain clauses to any agreement with the target (conditions precedent, warranties, etc.);
  - b) a change of strategy (choosing a different way of cooperation than the one initially intended);
  - c) if any risk outweighs the benefits of the intended cooperation, walk away from the deal.

#### 5.2 The due diligence list

As discussed earlier (see 4.4), the due diligence checklist should be delivered to the target company in Chinese. To avoid misunderstandings, the use of a bilingual list (English/Chinese) is most appropriate. Make sure that the translation of every item is accurate. Not every translation agency is equipped with personnel proficient in all legal, financial and technical terms of both languages. It is therefore best to have a law firm with bilingual staff either prepare the whole due diligence list right from the beginning or at least have it check both language versions. The following list gives an example of the most common items with regards to transactions in China. You will find more detailed information in later chapters, in which we will highlight certain items of special importance.

**General information about the target company**

- 1) Establishment/registration(s)
- 2) Organisational structure
- 3) Required permissions/licences
- 4) Local industry policies and favourable treatments

**Assets**

- 5) Real estate
- 6) Land use rights
- 7) Buildings
- 8) Movable

**Material contracts**

**Labour and social insurance**

- 9) Employee details
- 10) Employment contracts
- 11) Social insurance issues
- 12) Pensions etc.

**Intellectual property rights and technology transfer**

**Financial position**

- 13) Accounts
- 14) Funding
- 15) Liabilities

**Taxation**

- 16) Current situation
- 17) Transactions affecting taxation

**Other matters**

- 18) Product liability
- 19) Environmental issues
- 20) Foreign exchange control
- 21) Legal proceedings
- 22) Antitrust law

## 6 Scope of due diligence in China

In general, due diligence should cover all areas that are important for the transaction as well as post-transaction integration and operation of the target. **This is not limited to legal, financial and tax issues, but should also take include sound commercial and reputational due diligence as well as technical, environmental and risk management questions.**

The following will focus on the most important issues for any due diligence in China. In many cases these are also the areas in which significant differences to the situation in many western countries are noticeable.

### 6.1 Establishment of the target company

An investigation into a target company usually starts with checks on the legal status of the target company. In China, every company has to have a business licence to prove its legal status.

When investigating the legal status of the target company, the following aspects and documents are of significance:

#### 1) Business licence and related documents and certificates

The business licence is the most basic document a Chinese legal entity needs to possess. It proves the legal status as a legal person and indicates the permitted scope of business. Without a proper business licence, no entity is allowed to do business in China and, if in possession of a valid licence, business is limited to the scope of business as set forth in the licence. During the due diligence process the business scope indicated on the business licence of the target company should be checked against the actual business the company engages in. Due to the constant changes in China's business environment some companies neglect to adjust their legal scope of business to match their actual needs. In cases like this, the risk of severe consequences is high and increased transaction costs can be expected, as the licence will have to be adjusted. Another item to note on a business licence is the name of the legal representative of the company, as by law this is the only natural person entitled to sign legally binding documents and responsible for any action of the company.

The business licence is issued in one original and an official duplicate. Both should be checked for any inconsistencies as well as the latest annual check report.

Along with the current business licence, former licences should be checked as well to be able to track back the development of the company.

#### 2) Approval documents

Some companies, especially if their business is related to international trade or they are active in certain sensitive industries, need further approvals from authorities such as the National Development and Reform Commission (NDRC), the Ministry of Commerce (MOFCOM) or other authorities to operate legally. It is part of legal due diligence to examine all available approval documents and check them against all approvals necessary for the operation of the business.

#### 3) Registration documents

Every company in China is registered with various government authorities pursuant to applicable laws and regulations. These authorities may include customs, the local tax authorities, or, if they

use foreign currency, the State Administration of Foreign Exchange (SAFE). All of them issue certificates upon registration, such as the **organisational code certificate**, the **statistics certificate**, the **customs registration certificate**, etc. All these certificates need to be checked to avoid any risk of getting involved in compliance issues with one of the relevant government authorities.

#### 4) Capital structure and capital contribution

Documents related to the registered capital, the total amount of investment and the contribution of capital should also be analysed. This list should also include the investment verification report and the capital contribution certificate. Any transfer of shares or equity interest as well as the use of any equity or shares as security should also be checked via the relevant documents.

#### 5) Bank accounts

Look into documents proving the existence and normal use of bank accounts operated by the company.

#### 6) Other documents of importance

Apart from the above mentioned documents there may be others, specific to the kind of business the target is engaged in (approvals, permits, licences, etc.), that are also of importance and need to be checked carefully.

In addition to the documents mentioned above, copies of all documents filed with responsible authorities should be checked.

## 6.2 Corporate structure of the target company

As the corporate structure of a target company is an important factor for its operational success, it should be analysed carefully as part of any legal due diligence.

The following important aspects should be checked (if applicable):

#### 1) Constitutional documents

Any Chinese company needs to keep articles of association, and joint venture companies additionally need to keep a joint venture contract, which will reveal the corporate structure of the company in question. All changes to these documents have to be documented via amendments. These changes to the constitutional basis of the target company need to be included in the due diligence audit. Thus all amendments to the constitutional documents need to be reviewed, as do all documents relating to changes to the registered name or address of the company.

#### 2) Extended business of the company

Due diligence should also cover details of all domestic and overseas subsidiaries, branches, representative offices, distribution centres, R&D operations, associated enterprises or any other business operated or invested into by the target company, including their business licences, approval and registration documents.

### 3) Corporate governance

In relation to corporate governance, the following documents need to be provided:

- an organisational chart including a comprehensive department chart with a headcount of each department;
- a list of all current directors and supervisors of the company and the senior management, as well as other key personnel, including their names, age, remuneration and contact details;
- minutes and resolutions of the meetings of all organs of the company covering at least the last three years;
- internal company rules and policies;
- other relevant documents.

#### 6.3 Main assets

Many risks may be hidden in the assets of a target company. Assets are the means for the operation of the company and many deals are specifically done to get access to them. Therefore, no matter what deal structure is intended, a detailed assessment of the assets of the target is inevitable and should be a major part of the due diligence process. This is as true for asset deals, which aim right at the assets, as it is for share deals or joint ventures, as these will also make use of the assets during operation. In the case of joint ventures, the Chinese party will often use its assets as contributions as well.

The investigation into the assets can be divided into two parts:

1. the existence or composition of a certain asset; and
2. the scope or usability of such asset for the intended purpose before and after the transaction.

In other words, every existing asset (first part) should subsequently be checked for availability for the intended use (second part). A due diligence scheme regarding assets could look like this:

- 1) Composition / existence
  - a) land use rights and buildings;
  - b) fixed assets, including vehicles and equipment;
  - c) stock;
  - d) intellectual property (rights) and technological achievements;
  - e) products;
  - f) other assets.
- 2) Usability / restrictions in ownership or usability (if applicable)
  - a) completeness of licences/registrations;
  - b) encumbrances (rights of third parties, mortgages, pledges, liens, guarantees, etc.);
  - c) depreciation, function and merchantability;

- d) restrictions (for example, land use rights may be for industrial / residential / agricultural use only);
- e) licences to third parties / transfers;
- f) other restrictions (for instance vehicle number plates in Beijing, as driving restrictions there only allow vehicles with certain numbers on their plates to be driven on certain days, etc.).

### 6.3.1 Land use rights and buildings

Among all assets, **land use rights** play the most significant role in the due diligence process, not only because of their importance for the operation of most businesses, but mainly because of the major differences in the legal framework for real estate in China when compared to many western countries.

Since the completion of the land reform in China, private ownership of land has been abandoned. Instead, urban land is owned by the Chinese state, whereas rural land is owned by collective enterprises. Following economic needs, however, China has developed a comprehensive system of land use rights. Owners of land use rights can possess, profit from, use and manage a certain piece of land for a specific term or without time limit.

Any due diligence regarding land use rights should focus on whether they have been obtained in line with laws and regulations. In the past, foreign-invested enterprises have run into severe problems because the land use rights contributed by a Chinese partner were in fact not transferable.

#### 1) Collectively owned rural land

The right to use collectively owned rural land **cannot be obtained by a private entity** because there is no legal framework for such transactions. The land needs to be converted into state-owned land before the right to use it can be the object of any investment.

#### 2) State-owned land

The right to use state-owned land can be obtained from the Chinese state in two ways: by way of grant (granted land use right), and by way of allocation (allocated land use right).

##### a) Allocated land use rights

Land use rights obtained by way of allocation **cannot be transferred** to another party and thus cannot be part of any transaction involving the use of the land. If such land use rights were to be contributed to a joint venture, they would first have to be converted into granted land use rights.

##### b) Granted land use rights

Only land use rights obtained by way of a grant can be leased, used for security purposes or transferred to other parties as, for instance, in in-kind capital contributions.

##### c) Significance for due diligence

Whenever land use rights are involved in any transaction, the documents evidencing such rights need to be checked thoroughly. It needs to be determined whether the land use right in question is available for any transfer and whether the grant of the land use right includes the purpose for which the land shall be used after the transaction (production, office space, lease, etc). If this is not the case, the planned business venture might be deprived of the material

basis for its operation – the right to use the designated land – by the respective authorities, sometimes even years after the closing of the transaction.

This is of current importance as in recent years land was often seized for prestigious and potentially lucrative property development purposes without going through the necessary procedures. As the Chinese government is now trying to put a stop to these activities, many of the owners of these properties might face legal consequences in the future.

### 3) Buildings

While land cannot be privately owned, buildings and parts thereof can. Under Chinese law, ownership of the land and ownership of the buildings on the land are separate issues. Therefore, apart from the land use rights, the ownership of any building has to be examined separately. It has to be noted that the acquisition of a building always also requires the acquisition of the related land use rights.

To conduct due diligence on land use rights and buildings, it is necessary to check the following information:

- 1) Details regarding all sites and buildings occupied by the target company and its affiliates.
- 2) Information regarding the acquisition/transfer of land use rights and buildings. Special attention should be paid to documents such as land use rights certificates, real estate title certificates and building ownership certificates. The following information is of special interest:
  - a) registered holder of the land use right;
  - b) nature of the land use right (collectively owned / state-owned);
  - c) compensation payment requirements or other details if the land was administratively allocated;
  - d) purpose of the land use (industrial, commercial, residential, etc.);
  - e) duration of use;
  - f) location and area of the land plot (best verified through a visit to the site);
  - g) other conditions and suitability for the intended use.
- 3) Information regarding payments made in relation to any premises (lease rates, fees etc.).
- 4) Zoning options and governmental policies regarding the land in question.
- 5) Details regarding the lease of any premises (lease agreements, lease permits, etc.). If premises are leased from other parties, lease payments should be checked.
- 6) Encumbrances (mortgages etc.) and other related information regarding the premises like insurance, disputes or expected disputes in respect to the premises, etc.
- 7) Information regarding the construction of any buildings, from construction contracts etc..

#### 6.3.2 Intellectual property (rights)

Intellectual property rights (IPR), including trademarks, patents and the like, are valuable assets for any investor. In fact, in some cases they might be the reason for the transaction in the first place. Although complaints about the slow implementation of an effective intellectual property rights

protection regime persist, China has established a comprehensive legal basis for this and is constantly improving its implementation. However, to be able to benefit from this regime, it is important that the target company possesses an effective intellectual property management system, that the intellectual property owned is legally protected, and that the IP used was obtained legally. Due diligence in IP should focus on the following:

- 1) List of, and documents related to, patents, copyrights, trademarks and other intangible assets owned by the company, including registered rights and pending applications. Regarding patents, it is advisable to check the list of inventors carefully.
- 2) List of all intellectual property used but not owned by the company:
  - a) with contractual basis (licence, transfer agreement, etc.) for its use;
  - b) without contractual basis for its use.
- 3) List of all intellectual property used by others and owned by the target company:
  - a) with contractual basis (licence, transfer agreement, etc.) for its use;
  - b) without contractual basis for its use.
- 4) Measures and actions taken to protect any infringement of intellectual property rights.
- 5) Policy and incentive schemes for employee inventions, patents etc. and their implementation in labour and other contracts. Regarding patents, it is advisable to have the list of inventors checked carefully, as it is not uncommon for the head of the company or members of the senior management to have themselves listed too, to be able to take part in the incentive scheme. This would make the use of the invention more expensive for the investor and should therefore be considered.
- 6) All pending or expected disputes regarding intellectual property or the use thereof.

For more general information on IP issues in China, please visit the website of the China IPR SME Helpdesk at [www.china-iprhelpdesk.eu](http://www.china-iprhelpdesk.eu).

#### 6.4 Other assets

All other main assets should be verified based on the information and documentation appropriate for such assets. Such information / documents may include:

- 1) audited financial statements;
- 2) information on all assets with a value above a certain benchmark, depending on the size of the target and the transaction;
- 3) equipment used by the target;
- 4) details on all vehicles and vessels including number plate information.

#### 6.5 Material contracts

Material contracts entered into by the target company that affect or might affect the operation of the company shall also be checked and reviewed for any potential legal or other risks. Which contracts are considered material will need to be defined in the due diligence list. For this purpose, a certain

threshold for the material exchange governed by the contract has proven to be very useful, as for instance all contracts with a contract value of more than RMB 100,000 or a certain percentage of the company's consolidated net assets.

The Chinese Contract Law follows a codification system. Its basic principles are laid down in the PRC General Principles of Civil Law (GPCL), the PRC Contract Law and several other laws and supplementary interpretations of the supreme courts. Therefore, the wording of all contracts has to be interpreted on the basis of these laws and regulations. Some content may be provided by the laws mentioned above, even if the contract itself does not provide for it. This contingency should not be underestimated and the contracts need to be checked by experienced professionals familiar with Chinese law and regulations and its current implementation.

All issues regarding the establishment, validity and execution of the relevant contracts need to be verified and evaluated for their risk potential. This also includes any special rights, quotas or permits required under PRC law for execution of these contracts.

#### 6.6 Labour contracts and social insurance

Although labour contracts are part of the material contracts, it is appropriate and common to check them separately. This is so not only because of their special significance for the transaction and post-transaction integration, but also because of the growing complexity of labour law and social insurance issues in China. For any M&A it is important to know that according to article 34 of the PRC Labour Contract Law, the original labour contracts shall remain valid and have to continue to be performed by the merged or new employer, who inherits all rights and obligations in respect to any labour contract.

The Chinese labour law is developing rapidly, so it is necessary for the due diligence team to be up-to-date with the latest developments to avoid any risk, be it potential labour disputes or fines for violation of labour rights, which are possible in China. To accurately assess the potential risk, you need to be aware that China has recently strengthened the position and the rights of employees. Employees in China are well protected against (unlawful) dismissal. Even if a fixed-term labour contract is not being renewed at the end of its term, a severance payment is mandatory, and the same applies to any lawful dismissal. For unlawful dismissals, damages have to be paid. In addition, there is a limit to the number of consecutive fixed-term labour contracts, violation of which might lead to the right to an open-ended contract, as well as a strict regime for salary payment, overtime work and work on holidays, which may result in claims for compensation if not paid or not paid in time. Many of these claims can be made even after an employee leaves the company. This can amount to significant risks if not handled and controlled with care. At the very least, the investor should be aware of any possible claims should a restructuring of the work force be considered after the transaction.

From experience, compliance with labour laws and worker's rights is to some extent more common in foreign-invested enterprises than in Chinese private or state-owned enterprises. One reason for this is the fact that many of the rights mentioned above have been introduced rather recently with the establishment of the PRC Labour Contract Law, which came into effect in January 2008. Many companies have not yet changed their labour contracts and employment policies accordingly. A second reason might be that foreign-invested enterprises are more likely to get involved in labour disputes while domestic enterprises manage to solve issues in other ways. As with any cross-border transaction a domestic company turns into a foreign-invested company, these issues must be taken

seriously. Governmental control also seems to be stricter for foreign-invested companies. The reason behind this, however, is not a tendency to discriminate against foreign investors. Many domestic enterprises, especially state-owned companies, have established and maintained close relationships with the officials of the respective authorities, which to some extent might be able to use their discretionary authority in favour of those companies. These relationships might not always be maintained after the transaction, due to changes in personnel or other circumstances connected with the transaction. In any case, the due diligence process should reveal all potential risks in that respect and, if possible, come up with solutions on how to reach compliance in every aspect.

Another problem foreign investors might encounter is heavy overstaffing by the prospective partner. The reasons might be cultural or historic, but from a business stand point this issue has to be addressed as the restructuring of a company's work force is often a logical consequence of an M&A transaction. Joint venture projects do not have this particular problem, as they establish a new company which can build up its own work force according to its real needs.

Social security has also been strengthened in China in recent years. Today, employers are obliged to pay the bulk of their employees' pension as well as unemployment-, maternity-, health- and work-related accident insurance. Responsibility for these payments lies solely with the employer in China.

Finally, working conditions and the safety of the workplace can bear significant risks as regulations in this area have been expanded as well.

In summary, the following issues should be addressed during due diligence:

- 1) Information about all employees:
  - a) job description;
  - b) salary (payroll record);
  - c) contract term;
  - d) age;
  - e) employees without written labour contract.
- 2) Standard labour contract of the company and contracts with divergent terms, including special arrangements with management and key personnel.
- 3) Salary payment and compliance with payment schemes including overtime compensation and contribution to any social insurance.
- 4) Labour union and its activities.
- 5) Staff motivation schemes and option plans:

To retain key personnel in a labour market where skilled workers are in high demand and work opportunities are growing rapidly is key to ensuring a smooth post-transaction transition and operation.
- 6) Company policies regarding worker's safety and hygiene.
- 7) Non-competition issues.
- 8) Arrangements with former employees, board members and other personnel that are still in force.

- 9) Visa issues, in case foreign personnel is employed.
- 10) Any pending or expected disputes with employees or government authorities regarding labour issues such as labour contracts, working hours, salary, overtime work, work safety, etc..

## 6.7 Commercial and financial due diligence

In commercial and financial due diligence two main issues have to be distinguished: the external financing of the target on the one hand and the internal finances on the other. While financing is concerned with the capitalisation and the capital structure of the target, internal finances are concerned with the cash flow and the accounting of the target. Although, systematically speaking, financing belongs to the establishment of the company, aspects of it might as well be dealt with together with the financial due diligence, because they are closely related and dealt with in the same department of the target. At some point during the due diligence process, the accountant will have to check all financial matters, including the figures regarding the financing of the target.

The following information and documents should be checked and analysed for any risk:

- 1) External financing:
  - a) loans, including shareholder loans provided to the target and other obligations;
  - b) schedule of all options, warrants, rights and any other securities provided to third parties;
  - c) securities provided to the target or its affiliates by third parties.
- 2) Finances / accounting / operations:
  - a) annual audited financial statements of the past financial years;
  - b) monthly un-audited financial statements;
  - c) payable and receivable accounts;
  - d) monthly management accounts for the past years;
  - e) financial and liquidity plans, cash-flow calculations;
  - f) pension liabilities: these are often not accounted for on balance sheets (especially in SOEs) and must therefore be checked separately (see also 6.6), as they can amount to a significant value;
  - g) definitions of key profit & loss lines;
  - h) summary of accounting policies and internal standards;
  - i) finance team organisational chart with roles and responsibilities;
  - j) schedule of favourable policies provided by the government;
  - k) bank accounts;
  - l) details of the product pricing methodology;
  - m) process maps for key processes;
  - n) summary of product pricing and credit management processes.

## 6.8 Taxation and customs

As compliance issues in the field of taxation and customs in China bear a tremendous potential for civil, administrative and also criminal liability, it goes without saying that careful due diligence must cover these issues as well. Under-reporting of tax is not uncommon in Chinese, and especially among state-owned enterprises. The circumvention of custom duty liabilities is a classical problem in certain industries as well. Because of this, the following issues, information and documents (amongst others) need to be analysed carefully:

- 1) Overview of tax compliance issues of the target company.
- 2) Use of preferential tax policies by the target company (tax holidays, exemptions, reductions).
- 3) Overview of the current taxation of the target company.
- 4) Deed tax returns and the tax payment receipts for the last five years.
- 5) Taxes to be withheld by the target as a withholding agent. For instance, Chinese companies are obliged to withhold individual income tax (IIT) from payroll. Underpaid IIT may create extra liabilities.
- 6) Import and export duties.
- 7) Outstanding tax / customs duty liabilities.
- 8) Probability of any tax fines.

Apart from the taxation issues of the target company, the taxation of the planned transaction needs to be carefully analysed as well before making a final decision on the transaction structure. During the transition phase, the resulting strategy will then have to be executed in compliance with the relevant laws.

## 6.9 Other issues

In this chapter, some important issues will be addressed which may not be relevant for all transactions, but which are of great importance and need to be managed accordingly if applicable.

### 6.9.1 Product liability

Following several scandals in the food industry as well as in the manufacturing of toys and other consumer product industries, the Chinese government has greatly strengthened its efforts to streamline and improve its product liability regime. Most recently, the PRC Tort Liability Law entered into force in 2010, introducing a chapter especially on product liability. Under the new regime, manufacturers of defective products may be held liable for losses and injuries caused by a defect product. Proof of the fact that the injury or loss is a consequence of a defective product is enough to allow charges against the manufacturer and the resulting liabilities can easily put the whole operation at risk. Only if the manufacturer can prove that the defective product was not circulated, the defect causing the loss, injury or damage did not exist at the time of circulation or could not be detected at the time of circulation using the scientific and technical means available at that time, can he be exonerated. Sellers of defective products are subject to fault liability according to the PRC Product Quality Law and the PRC Tort Liability Law.

Apart from that, if a product is exported to another country, the laws and regulations of that country might be applicable. In that case, due diligence should also cover the technical and legal standards of the countries to which the products of the target are or are expected to be exported to in the near future.

In addition to any technical due diligence, investors intending to invest into a production company should pay attention to the following issues and documents:

- 1) contracts and contract clauses covering product liability (recall policy, legal costs, etc.);
- 2) risks of product liability issues in the current line of production;
- 3) recall history.

### 6.9.2 Bribery and corruption

The fight against bribery and corruption is another area in which the Chinese government is becoming more and more active. As corruption is still rather common and poses a threat to the smooth growth of the economy and the harmonious development of the Chinese society, it has become a focus of the current administration. It is therefore not surprising that any illegal activity in this respect might trigger serious consequences, including private claims, administrative penalties and criminal law charges. In addition, acts of corruption may in certain cases also be punishable in the home country of the investor, as for example in the US with the US Foreign Corrupt Practices Act or Great Britain with the 2010 Bribery Act.

For these reasons, amongst others, it is unacceptable to turn a blind eye on such issues. As these activities are usually not engaged in or discussed openly, it is not easy to unearth any information on them during the due diligence procedure. Therefore, the search for any hints or clues on such 'sensitive' activities or payments needs to be part of the checks performed in other parts of the process, most notably during the review of financial reports. Irregularities may indicate questionable practices which can then be investigated discretely.

A request for a formal statement to the effect that the target enterprise has never participated in illegal practices of this kind is possible, but might affect the relationship with the senior management of the target company and should be handled carefully on a case-by-case basis. The following circumstances may provide clues to irregular or illegal practices and should be considered:

- 1) irregularities in financial statements;
- 2) irregular client accounts;
- 3) expense accounts;
- 4) expense policy/reimbursement of expenses.

### 6.9.3 Environmental issues

With rising levels of smog in major Chinese cities including Beijing and Shanghai, a number of environmental disasters and a growing awareness of the seriousness of the environmental problems at local and central government levels as well as within the population, environmental protection is becoming more and more important. Rather flexible rules and lagging implementation of environmental laws in combination with a lack of effective controls may have led to the neglect of

this issue at the target company. Due diligence should reveal any compliance issues concerning existing environmental protection laws and regulations highlight potential risks. The following information and documents might be helpful for this process:

- 1) Current environmental situation, especially in relation to environmentally sensitive activities or environmentally dangerous substances, hazardous waste, etc., used or produced by the target.
- 2) Environmental permits, licences, authorisations, registrations and approvals.
- 3) Any known cases of breaches of any licence authorisation, registration or approval.
- 4) Any case of prosecution or claim in the past against the target concerning environmental issues.

#### 6.9.4 Antitrust

In 2008 China enacted its new Anti-Monopoly Law (AML). Since then, the Chinese authorities are playing a more active role in investigating and controlling monopoly tendencies. This development might not be relevant for smaller transactions involving small and medium-sized companies. However, it is worth paying some attention to this issue, especially in small markets with relatively few participants. The following issues should be kept in mind:

- 1) market share of the target company and all its subsidiaries and affiliated companies;
- 2) involvement in antitrust procedures.

#### 6.9.5 Litigation and arbitration

Finally, all current and potential legal proceedings need to be checked for inherent risks. The outcome of a legal procedure in China is still not as predictable as in Europe. Any actual or potential litigation cases should be evaluated in relation to the possibility of reaching an agreement with the opponent.

Due diligence regarding legal proceedings may include:

- civil litigation, arbitration and mediation in China and abroad;
- criminal litigation or prosecution;
- administrative litigation or mediation;
- decisions or orders of any governmental authority;
- awards in favour or against the target company by any court or other government authority;
- any settlement with any other party.

## 7 Formalities and document verification

All documents received from the target enterprise should be formally verified by the target company. The most important ones and those which raise questions as to their authenticity or reliability need to be cross-checked using outside help, as explained above (see 4.2.4). It is not advisable to confront the target company with open distrust and suspicion by questioning all documents presented during due diligence. A thorough assessment is nonetheless appropriate, especially for major issues. Some cross-referencing methods, like cross-checks with authorities or telephone calls to verify certain issues, are

rather simple and very cost efficient. To omit them would be negligent. For more delicate issues, which would require a more extensive investigation, we suggest evaluating the risks of omitting such an investigation against its possible outcome, as in some cases a worst case scenario simulation will reveal that the involved risk is lower than the costs for an in-depth investigation. For material issues, however, neglecting to investigate could put the whole operation at risk and is therefore not an option. The following ways to verify documents are common:

- 1) The target company should affix a company seal to any document or copy provided to the investor. This seal serves two purposes, the first of which is of a rather psychological nature: using the company seal shows the sincerity of the target company's efforts to provide you with accurate documentation by attributing responsibility for authenticity and correctness. Secondly, the use of the seal helps avoid any dispute about which documents have been provided or disclosed and leaves no doubt that such documents have been obtained legally.
- 2) Documents that have been originally issued by governmental authorities should be cross-checked with the issuing bodies. These most commonly include:
  - a) Business licences and registrations – to be cross-checked with the Administration for Industry and Commerce (AIC).
  - b) Land use rights and building ownership certificates – to be cross-checked with the competent Land Bureau and Housing Bureau.
  - c) Trademark certificates can be researched online at the website of the Trademark Office of the State Administration of Industry and Commerce.
  - d) Patents can be searched at the China Patent Information Center (CPIC) of the State Intellectual Property Office (SIPO).
  - e) Trade associations and chambers of commerce can back up the credibility of a target and to a certain degree confirm its business history.

Please note that most governmental authorities need the consent of the target company to be able to disclose documents to third parties.

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## 8 Particular problems with state-owned enterprises and problems particular to China

When working with state-owned enterprises (SOEs), there are some additional issues to keep in mind:

- 1) Until the mid-nineties, allowing foreign professionals access to financial and operating records of an SOE would have constituted a violation of China's state secret regime and could have been subject to investigation and punishment. Therefore, employees of state-owned enterprises are used to handling information on a strict "need-to-know" basis. Investors should therefore expect a rather uncooperative approach when it comes to gathering information on such a company. Any request, if answered at all, will most likely be handled in a strictly positivistic manner, i.e., it will be interpreted restrictively according to the literal meaning of the words. This makes it necessary to pay a lot of attention to the wording of any request, especially the due diligence list itself.
- 2) Under-reporting of taxes, complicated debt and security arrangements, the underfunding of employee social welfare obligations and incomplete evidence of titles to the use of land and

buildings (as discussed in previous chapters) are other problems more commonly associated with SOEs.

- 3) Even though China has made great efforts to base its legal system on publicly promulgated laws, it is still important to keep in mind that many aspects, especially regarding the implementation of laws and regulations, are governed by unmodified regulations of the respective governmental bodies. It might thus be useful to gather as much information as possible on those un-codified regulations influencing the target company.

## 9 Case study<sup>3</sup>

As the following case study will show, thorough due diligence can reveal unexpected risks and problems at any stage of the negotiations between the partners.

A-Pharma is a corporate group engaging in research and development, production and distribution of organic pharmaceuticals. In order to strategically expand its business and diversify its range of products, A-Pharma was looking for an M&A target on the Chinese market. After some in-house research they quickly found a perfect fit, the Bio-Med Company. Through negotiations with Bio-Med and the information and documents received from them, they established that Bio-Med's business model was based on three products, X, Y and Z, which A-Pharma would have liked to incorporate into their product line. The medical licences for Y and Z, which had only been added to the portfolio recently, had not yet been issued but were easy to obtain. A-Pharma decided to acquire 100% of the shares of Bio-Med with the goal of obtaining ownership of its three main products. Upon request of Bio-Med a letter of intent was signed and an escrow account opened as guarantee for its performance. Among other things, it was warranted that Bio-Med owns the rights to the products X, Y and Z. Both parties, ready to take action, were looking forward to the next steps.

Although the investment was not very substantial, A-Pharma decided to engage external lawyers to conduct due diligence on the target as a matter of precaution. This exercise, which followed the outline proposed in this guideline, revealed the following:

### a) Establishment and corporate structure of the target company

Bio-Med was operating as a limited liability company. A reference check at the Administration for Industry and Commerce (AIC) revealed that, for historical reasons, Bio-Med was established in 2003 in the form of a joint-equity cooperative enterprise and this status had never officially been changed.

A reference check with the respective authorities also revealed that Bio-Med was not registered as a pharmaceutical manufacturing enterprise as had been suggested, but as a medical research institute that never obtained a pharmaceutical manufacturing licence necessary to produce medicine of any kind.

### b) Main assets

The main assets this transaction was targeting where the three products X, Y and Z, whose ownership was investigated as part of the due diligence process. It turned out that the ownership claimed by Bio-

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<sup>3</sup> The names of companies, persons and organisations have been changed, irrelevant facts have been omitted.

Med was based merely on a drug cooperative development agreement between Bio-Med and a third company, C, according to which the rights to the drugs were to be transferred to Bio-Med. Although this contract was duly signed, a background check with the relevant authorities showed that such transfer of ownership had, in fact, not taken place. The drug registration certificate still showed company C as the owner (manufacturing enterprise) of all three products. As the obligation contained in a contract does not automatically cause an effective change of ownership in China, Bio-Med never legally obtained ownership of the products or its manufacturing technology. Apart from that, the signed contract between Bio-Med and C violated drug registration laws and was therefore void or at least not enforceable.

c) Intellectual property rights

Bio-Med claimed to be the owner of the patents of the three products in question. A review of the original patent certificates and a cross-check with the database of the State Intellectual Property Office confirmed the existence of such patents. However, the right to the use of the patent for product Y was based on a licence agreement. A check on the licence agreement revealed that the patent was co-owned by two parties, Bio-Med and a natural person, Mr. Li. Mr. Li, however, explicitly stated that he did not agree to the unilateral licencing, nor did he consent to the transfer of his part of the patent. Therefore, the due diligence lawyer in charge predicted a high risk for this arrangement to be challenged in the future.

Apart from the above, due diligence revealed that a direct competitor, company D, was producing and distributing a product very similar to product Z. Research showed that apart from Bio-Med, two other companies, including D, had obtained the drug approval certificate for product Z before 2008, the year in which Bio-Med's patent was approved. According to Chinese laws, company D would thus have been able to obtain the priority usage right for this patent on the grounds that their application for the drug approval certificate had been filed earlier than the patent application of Bio-Med. An analysis of D's product confirmed that it was almost identical to product Z, and technicians from both Bio-Med and company C highly suspected the use of their patented technology for its production, even though direct evidence could not be obtained with the means available.

d) Conclusion

Despite the initial hopes of having found the perfect partner, due diligence revealed high risks connected to the transaction and subsequent operation, which could not be overcome by any carefully drafted contract, warranty or other legal safeguard. As the target was legally not qualified to make the intended transaction, it would have been very difficult to get approval from the relevant authorities. Further negotiations with Bio-Med would not have helped either, as many of the disputed issues were not within their power of disposal. As a consequence, A-Pharma was able to step away from the transaction before any of the risks could realise, thus preventing potentially large losses and resource-intensive lawsuits.



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