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Top Five Traps in M&A Transactions in China

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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.

Good Faith in England

by Mark Crofskey

Parties entering into transactions in varied jurisdictions frequently include a contractual provision under which they agree to act in good faith towards one another. The recent High Court decision by Vos J in *CPC Group Limited v. Qatari Diar Real Estate Investment Company* ([2010] EWHC 1535 (Ch)) (*CPC v. QD*) explores this legal shorthand when undertaking transactions under English law.

CPC and QD entered into a joint venture to develop the Chelsea Barracks site in London, having purchased the site from the UK government for £959 million in 2007. A planning application was made for the re-development of the site, and CPC sold its interest in the joint venture to QD.   Under the sale and purchase agreement (SPA), there were significant deferred payments due to CPC contingent on planning permission being progressed, and both CPC and QD owed each other an express duty to act in the “utmost good faith.

In March and May 2009, the Prince of Wales made known to his Qatari royal contacts his dislike of the proposed re-development. In June 2009, QD withdrew the planning application. One of the main issues of the case concerned whether either party to the case had acted in breach of their duties of utmost good faith in the events following the Prince of Wales’ intervention, which gives a good place to start an examination of what this commonly used term means in English law.

The Meaning of "Good Faith" – Reasonable Commercial Standard of Fair Dealing

Vos J noted the lack of English authority as to the meaning of the obligation to act "in the utmost good faith.

In reaching his decision, Vos J agreed with Morgan J's judgment in *Berkeley Community Villages Ltd v. Pullen* ([2007] EWHC 1330 (Ch)), which in turn relied upon French J's analysis of good faith in *Bropho v. Human Rights & Equal Opportunity Commission* ([2004] FCAFC 16). French J consulted a plethora of legal articles and textbooks, including the *U.S. Second Restatement of Contracts*, which states, "good faith performance or enforcement of a contract emphasises faithfulness as to an agreed common purpose and consistency with the justified expectations of the other party.

Vos J held that the obligation of utmost good faith in the SPA was to (i) adhere to the spirit of the contract, (ii) observe reasonable commercial standards of fair dealing, (iii) be faithful to the agreed common purpose and (iv) act consistently with the justified expectations of the parties. Given (iv), the business context will be determinative as to what is a reasonable standard of commercial dealing, and good faith will differ in relation to each and every contract, as the spirit and purpose of each bargain must be considered.

The Meaning of "Good Faith" – Parties' Own Commercial Interests

Courts have been reluctant to deny a party the right to take into account its own interests when operating contractual provisions that permit a party room for discretion or negotiation.

Vos J considered Australian authority, looking to *Overlook v. Foxtel* ([2002] NSWSC 17),which states that "the party subject to the [good faith] obligation is not required to subordinate the party's own interests so long as pursuit of those interests does not entail unreasonable interference with the enjoyment of a benefit conferred by the express contractual terms.

Vos J looked at the SPA as a whole. As a result of qualifications to other terms in the SPA, such as "if it is in their respective interests to make" and "all reasonable but commercially prudent," Vos J held that "the parties' commercial interests were not intended to be entirely subjugated." This suggests that any preservation of self-interest, whether express or implied in the contract, can severely limit the effect of an express duty to act in good faith.

Breach of Good Faith

Good faith has generally been interpreted narrowly as a negative requirement not to act in bad faith. This is reflected in *Medforth v. Blake* ([2000] Ch.86, Court of Appeal: "the concept of good faith should not be diluted by treating it as capable of being breached by conduct that is not dishonest or otherwise tainted by bad faith") and *Manifest Shipping Co v. Uni-Polaris Shipping Co* ([2003] 1 AC 469). In *Petromec Inc v. Petroleo Brasilero SA Petrobras (No.3)* ([2005] EWCA Civ 891), Longmore LJ provided insight into the meaning of bad faith: "in the absence of fraud it would be unlikely that there would be a finding of bad faith.

Vos J concurred with Lord Scott in *Manifest Shipping* that "it might be difficult to understand how, without bad faith, there can be a breach of a duty of good faith, utmost or otherwise," but did not comment upon whether such an obligation could only be breached by acting in bad faith. Vos J did not find that either party had breached the obligation to act in good faith.

This renders the legal effect of the good faith provision negligible, since it does not impose any substantive duty or obligation, other than not to act dishonestly, in relation to the bargain intended. Vos J did not find that the obligation to act in good faith had been breached in *CPC v. QD*, despite the behavior of the parties to the case.

Effect of Express Good Faith Provisions

Good faith depends on the particular context of the commercial relationship in which the duty is imposed. Express good faith provisions will be interpreted narrowly in relation to their capacity to fetter a parties' ability to act in its own best interests.

While the judgment in *CPC v. QD* has not radically altered the law in relation to good faith, Vos J believes that the current law has moved on from that in *Walford v. Miles* ([1992] 2 AC 128), where an express agreement to negotiate in good faith was held to be unenforceable.

There is a fine line between a party legitimately protecting its own commercial interests and a party behaving unfairly. The inclusion of an express term to act in good faith may be a source of uncertainty in the contract or may provide flexibility. Vos J discussed his judgment at the Chancery Bar Association Conference earlier in 2011, stating that should the parties choose to use such shorthand, any element of unpredictability is a risk borne voluntarily by them, to be interpreted in line with their reasonable expectations. In order to reduce uncertainty, parties should precisely define the scope of an express term to act in good faith, in relation to the acts covered, any subjugation of each parties' own interests and the consequences of breach.

Courts will respect freedom of contract and generally will not imply a duty to act in good faith into sophisticated joint venture contracts arising from full legal advice (*Bond Corp Holdings Ltd v. Granada Group* (unreported, May 17, 1991)). However, fair dealing concepts are already imposed in English contract law. The courts can rely on equitable principles, striking against unconscionable conduct and bad faith in contract performance ("Contract, good faith and equitable standards in fair dealing," *Law Quarterly Review*, A.F. Mason, 2000). Furthermore the general approach of courts to problems of interpretation in contract law is to uphold the reasonable expectations of the parties ("Contract Law: fulfilling the reasonable expectations of honest men," *Law Quarterly Review*, Johan Steyn, 1997).

*CPC v. QD*is only a High Court decision, but it has confirmed that express good faith clauses are capable of being upheld with drafting setting out clearly what it is that the parties seek to achieve, and that the courts will seek to uphold these clauses. The case also shows that "good faith" as legal shorthand is less useful from a legal perspective than it might be as a reference point for commercial negotiations.

German Antitrust Regulator Steps Up the Fight Against Gun-Jumping

by Martina Maier and Philipp Werner

More than 100 countries worldwide have merger control regimes, which require parties to reportable transactions to notify antitrust regulators and obtain competition clearance. The majority of these antitrust regimes, including the U.S., EU and most EU Member States, prohibit the parties from implementing their transaction during a waiting period, during which the regulator decides whether the transaction is consistent with relevant competition law. This means that parties to a transaction may not close a deal, or take steps to integrate the businesses during the waiting period – they must, in effect, "stand still" pending clearance or the expiration of the relevant waiting period.

Likewise, in Germany a reportable merger must not be implemented without clearance decision or expiration of the waiting period. Under German law, an infringement of the standstill obligation (so-called "gun-jumping") can lead to fines of up to 10 percent of the group's worldwide turnover. In addition to fines, parties that infringe the standstill obligation risk other consequences, including the possible invalidity of the measures implementing the merger, such as the transfer of shares or assets-- at least insofar as they are governed by German law.

The risks of gun-jumping are generally well understood. But companies should also be aware that the German Federal Cartel Office (FCO) has recently taken a more aggressive approach in its enforcement of gun-jumping, both concerning the treatment of *ex-post* notifications and the fining policy for gun-jumping.

1. *Ex-post* notification

In the past, when companies had, either voluntarily or by accident, implemented a transaction reportable under German antitrust laws without reporting it to and obtaining approval from the FCO, they could resort to "*ex-post* notifications" to legalize the implemented merger. The *ex-post* notification led to an *ex-post* clearance within the same deadlines that are applicable for *ex ante* notifications (one month deadline for a Phase I clearance). The *ex-*

post clearance validated the merger itself, as well as any measures taken to implement it. The risk of fines was relatively low, at least for first-time infringers, and in cases not involving serious competition problems.

This approach has recently changed. The FCO has published new practice guidelines concerning the handling of "*ex-post* notifications”. It will no longer treat these notifications within the statutory deadlines for notifications but will consider them as pure sources of information leading to the demerger procedure. In other words, instead of considering an “*ex post* notification” under essentially the same procedural rules as a *ex ante* notification, the FCO will instead assess whether the implemented transaction created competition problems and should therefore be "unscrambled" or “undone.”

For companies, this is bad news. First, they can no longer be sure to receive a clearance decision within any legally specified deadline after an *ex-post* notification. Although the FCO is bound by the principle of good administration, it cannot be forced to clear or assess the merger within a specific deadline. Second, as already noted, the measures that the parties to the merger take in implementing the merger can be deemed ineffective under German law without FCO clearance. According to the FCO, a positive outcome of the demerger procedure (*i.e.* without a decision ordering the demerger), will have the same effect as a clearance decision. But this may leave the parties with uncertainty because the demerger procedure will not in all cases lead to a final decision but may simply be discontinued. In any case, the companies may face the uncomfortable situation of ineffective measures and unenforceable contracts for an undefined period of time, even as first time offenders and even if the merger does not raise any serious competition concerns.

2. Fines for gun-jumping

In the past, the risk of fines was typically small if the merger did not present any serious competition concerns; if it was the group's first infringement of the standstill obligation; and if the company itself notified the FCO *ex-post* of the implemented merger. Although the FCO has never laid down this practice in writing, the decision practice was largely guided by these principles.

This unwritten policy, however, may be changing. Recently, there have been an increasing number of decisions imposing fines for gun-jumping. In the first five months of 2011 alone, the FCO has imposed fines in two cases. For example, in May 2011, the FCO imposed a substantial fine for the infringement of the standstill obligation against the German company Interseroh. Significantly, Interseroh had notified the FCO of the merger after its implementation (by means of an *ex-post* notification) and the FCO found that the merger did not give rise to any competition concerns. These facts were only taken into account as mitigating factors for the calculation of the fine. The fine imposed is far below the statutory cap of 10 percent of the group's worldwide turnover, but it is still a risk that needs to be considered in every case.

This increased enforcement activity of the FCO can be seen in its wider context of increased merger control enforcement in Europe. In light of the approach taken by the European Commission and other national competition authorities, gun-jumping is a threat at the European level as well as at the national level. For example, in 2009, the European Commission imposed a fine of EUR 20 million for the infringement of the standstill obligation against the Belgian public utility services group, Electrabel, and appears to be increasing its enforcement activity for gun-jumping.

3. Outlook

The filing requirement and the standstill obligation under German law cannot be seen as a pure formality. Gun-jumping leads to a risk of fines and to ineffective implementation measures. The recent change in the FCO's practice makes it more difficult to remedy this situation by means of an *ex-post* notification.

It is essential to always verify whether and in which jurisdictions a transaction is reportable, and to not close the deal before it has been cleared by the relevant competition authorities. Legal counsel must conduct thorough due diligence to verify whether prior acquisitions by the target have been approved by all relevant competition authorities. If this is not the case, the acquirer must take the appropriate (contractual or other) steps and safeguards against the risk of fines and of ineffective and unenforceable contracts concluded by the target. Particularly in mature competition regimes such as the U.S., the EU or Germany, where the risk is high, competition experts should be involved early on in the transaction to assess the notification requirements and the substantive requirements of merger control.

How to Watch Your EU Deals from an Antitrust Perspective

by Veronica Pinotti, Riccardo Franceschi and Martino Sforza

Compliance with EU and national antitrust merger control rules can significantly impact the feasibility, timing and costs of M&A transactions. If antitrust merger control rules are not considered in advance, they may ultimately become “deal killers.”

The parties need to assess, from early in the negotiations, whether the transaction may raise any competition issues. Therefore, antitrust counsel needs to be involved early in the process, and not only brought in during the final phase of the deal, in order to verify the feasibility of the transaction from an antitrust standpoint. For complex cases, it may be necessary to bring in antitrust counsel as far as two years before its expected implementation. Completing a timely antitrust review of a proposed transaction may allow the parties to save time and costs for the structuring of deals, that upon review are deemed to be infeasible, because they would likely be stopped by relevant competition authorities. In other circumstances, the early involvement of an antitrust counsel can help the parties define better strategies to minimize any potential competition risks raised by the transaction (*e.g.*, whether a pre-merger divestment or other structural or behavioral remedies should be offered to the relevant competition authorities) and address potentially problematic issues with the authorities.

Compliance with merger control rules remains important to ensure a smooth and unproblematic closing, and to avoid significant competition issues. A preliminary multijurisdictional merger control analysis is required to verify whether a transaction needs to be notified in any of the countries where the parties have a presence or do business, and assess its likely impact on the timetable for the closing. Within the European Union, transactions that have a so-called "Community dimension" (in terms of aggregate turnover of the parties, as well as the areas of activity) are notified and (in principle) reviewed exclusively by the European Commission, in application of a "one-stop shop" principle. Consequently, such transactions do not need to also be reviewed under the merger control regimes of each EU Member States affected by the deal. However, in certain circumstances the transaction may pose more complex jurisdictional issues. For example, if a transaction having "Community dimension," affects competition in a distinct market within a EU Member State, it may be referred (in whole or in part) to the local authority of that EU Member State. In turn, transactions without "Community dimension" may, in certain circumstances, be examined by the Commission, upon the request of one or more EU Member States or the Commission itself. In addition, local merger control regimes differ significantly from one another, on both procedural and substantial aspects. For instance, in most EU countries the merger control filing is mandatory if certain turnover or markets shares thresholds are met. But in other countries (*i.e*., United Kingdom), the filing is only voluntary (*i.e*., if the certain thresholds are met, the parties may notify the transaction in order to obtain a clearance by the relevant national authority, prior to the closing). In addition, there are jurisdictions which require the clearance of the relevant competition authority prior to the implementation of the deal (*e.g*., Germany and Austria), and others where it is sufficient to notify prior to the closing (*e.g*., Italy).

The Commission and the national competition authorities (NCAs) have been increasingly using their powers to ensure that companies comply with the merger control rules described earlier, in particular with those which set the procedural requirements of a filing. In May 2011, the German *Bundeskartellamt* imposed a fine amounting to EUR 206,000 on Interseroh Scrap and Metals Holding GmbH, for violating the prohibition to implement a merger before the notified deal was cleared. The Commission went so far as to levy a record fine of EUR 20 million in June 2010, against Electrabel (an electricity producer and part of the Suez Group) for failing to obtain prior approval for its acquisition of shares in Compagnie Nationale du Rhone. These fines were imposed despite the fact that the transactions did not give rise to competition concerns. It is very unlikely that this trend will change; rather, the antitrust regulators are expected to pay even more attention to the implementation of such rules in the future.

The Commission and the NCAs can impose significant fines for failure to notify a transaction or for its implementation prior to obtaining clearance (*e.g*., up to 10 percent of the parties global turnover, as far as the Commission is concerned). As mentioned earlier, such fines apply regardless of whether the transaction may have potential harmful effects on the relevant markets (although the lack of any substantive competition issues is considered *ex-post* as a mitigating factor). The authorities can also declare the merger to be illegal (*i.e.*, null and void) and order the total or partial divestiture of the merged entity (or adopt other appropriate measures regarding the implemented concentration). Furthermore, in certain countries, such as Ireland, "wilful and knowing" failure to notify a transaction within the determined time limit may constitute criminal offense, punishable with a fine from EUR 3,000 to EUR 250,000.

As a result, specialized advice from local counsel is needed from the earliest stages of a potential deal, in order to assess: (i) the feasibility of the deal from an antitrust standpoint and how to approach potential competition risks; (ii) whether the transaction needs to be notified in any jurisdiction where the parties have a presence or do business; (iii) whether the transaction shall be made conditional on the clearance of the relevant competition authorities; (iv) when the parties should start collecting the relevant data to prepare the notifications, in order to allow enough time to submit the filings and receive approvals from the relevant competition authorities (taking into account, among other things, the potential competition issues raised by the transaction); and (v) the best way to approach and manage communications with each authority.

Finally, the input of the local antitrust counsel is also essential to advise corporate lawyers on the contractual clauses that should be included or avoided in transaction agreements (*e.g.*, the antitrust condition precedent), the parties' warranties, or other covenants that the buyer or seller may impose on each other (*e.g.*, non-competition clauses set for a transitional period, commencing upon the closing date), which, under certain circumstances, may be considered ancillary to the transaction.

Compliance with merger control laws is sometimes underestimated. Parties to a proposed transaction in the EU should assess the merger control issues early in the process and evaluate and comply with any procedural antitrust requirements to avoid unnecessary delay, or even civil or criminal penalties, in any EU transactions.