Doing Business in China: Private Mergers and Acquisitions

China’s accession into the World Trade Organization (WTO) in 2001 inspired increased foreign investment in the emerging giant of the world economy. Foreign investors became enlivened by the expectation that China’s implementation of its WTO accession commitments would provide improved access to a key market supported by an increasingly predictable and reliable legal framework. Consequently, the past decade or more has seen significant developments in both China’s commercial law structure and the amount of foreign investment in China. Nonetheless, foreign investors must still navigate very challenging waters when attempting to acquire a company or business in China.

Approvals

Most acquisitions by an international purchaser of Chinese companies or Chinese assets will need approval by at least one governmental authority. Many acquisitions will need to be approved by the Ministry of Commerce (commonly referred to as the MOC or MOFCOM), whether at the local level or above. The approval is a substantive one but, provided the MOC’s requirements are satisfied, should be forthcoming within around three months (although the period can be longer or shorter).

Other approvals which are commonly required include State Administration of Foreign Exchange (SAFE) registration, which allows the international shareholder to remit profits out of the PRC; State Administration for Industry and Commerce (SAIC) registration for change of business license of the target company to reflect its new shareholder(s); and State Administration of Taxation (SAT) registration, amongst other things, to reflect new ownership.

In addition, some permits or licenses of the target may need to be re-issued to reflect the foreign ownership (even if the target’s business remains the same).

If the Chinese target is being acquired by a Chinese entity already established by the international purchaser, some of the above will not be required or will be simpler to obtain.

Value appraisal

Due to restrictions on the transfer of Chinese assets offshore, the value of the assets transferred will often need to be appraised in order to ensure that the consideration to be paid is in line with the value of the assets themselves. Such an appraisal is sometimes dispensed with when it is clear that the international purchaser is paying a full market price. Price adjustments often require separate approval.

Escrow/retention arrangements

Escrow or retention arrangements are relatively common on Chinese M&A acquisitions, in part because many sellers are individuals. Where these are part of any deal, a number of issues need to be considered, such as the common requirement that the entire purchase price must be paid within a year of completion.

Governing law and language

All documents to be submitted for approval to MOC and other relevant authorities will need to have a Chinese language version. In addition, MOC officials are normally reluctant to approve contracts where the English language version prevails. Accordingly, it is normal to provide that, at the very least, the English and Chinese language versions are of equal status. Running documents in both English and Chinese will add to the cost of any transaction and may affect timing.

The sale and purchase agreement (and certain other contracts) which are approved by the MOC will need to be governed by Chinese law. It is, however, possible to provide for foreign arbitration, often in Hong Kong or Singapore.

Representations, warranties and warranty limitations
The concepts of representations, warranties and conditions, which are well developed in common law jurisdictions such as the US and typically assume great importance in an acquisition, are not clearly distinguished under Chinese law. Accordingly, it is quite common to see contracts without warranty limitations, and some sellers may be unfamiliar with the concept of disclosing against or amending warranties.

If so, the seller may need help to disclose against the warranties and, given that the purpose of many representations and warranties is to elicit information (as opposed to having a right to sue later), this is normally a worthwhile exercise from the purchaser’s perspective.

**Indemnities**

Chinese courts may not recognize and enforce indemnities to the same extent as is permitted by some international jurisdictions. In particular they may only allow recovery of damages for foreseeable loss for breach of an agreement governed by Chinese law.

Indemnities can, however, still be included in acquisition documentation but purchasers need to be aware of their potentially restricted scope.

Accordingly, if there is a particular type of loss that is desired to be recovered, it may be helpful to state it explicitly and quantify it where possible.

**Issues under the PRC Contract Law**

Under the PRC Contract Law, the validity of certain types of provisions in any contract may be subject to challenge on the basis they breach the letter or the spirit of the Contract Law. This is due to the rather vague way in which the Contract Law is drafted.

For example, the principles of “voluntariness”, “fairness”, “good faith” and the need that the parties must comply with laws and regulations and respect public morality and not disrupt the social or economic order or damage the public interest when concluding contracts, could be used to challenge the validity of a contract as a whole or a particular provision of a contract.

Under Chinese law-governed contracts, certain exemption clauses are inherently void if they exempt a party from liability for personal injury to the other party or exempt a party from liability for property damage caused by that party’s gross negligence or willful acts.

Parties can still be liable in circumstances where no contract is entered into. For example, a party which causes loss to the other party is liable in damages to the other party if, during the course of negotiations relating to a contract it: (i) negotiated in bad faith under the pretence of concluding a contract; or (ii) deliberately concealed an important fact relevant to the conclusion of the contract or provided false information; or (iii) engaged in another act running contrary to good faith. Circumstances where this might come up are where the foreign party is separately negotiating joint ventures with several Chinese parties simultaneous and only plans to establish one joint venture, and does not disclose this to the Chinese party.

**Impact on multi-jurisdictional acquisitions**

All or some of the above issues will impact on how multi-jurisdictional acquisitions are structured. The need for governmental approval in particular may mean that purchasers will wish to have a separate closing for the acquisition of the target business in China and so not delay any main closing.

*For more details please contact Peter Corne, managing partner of Dorsey’s Shanghai office*