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# Dealing with Chinese Companies – The Legal Advisor's Point of View

Completing M&A Transactions Successfully with Chinese Companies, 3 November 2014

NKF

# Program – Dealing with Chinese Companies – The Swiss Legal Advisor's Point of View

1. Recent Legal Developments

   a. Free Trade Agreement (FTA) China – Switzerland
   b. Double Taxation Agreement (DTA) China – Switzerland
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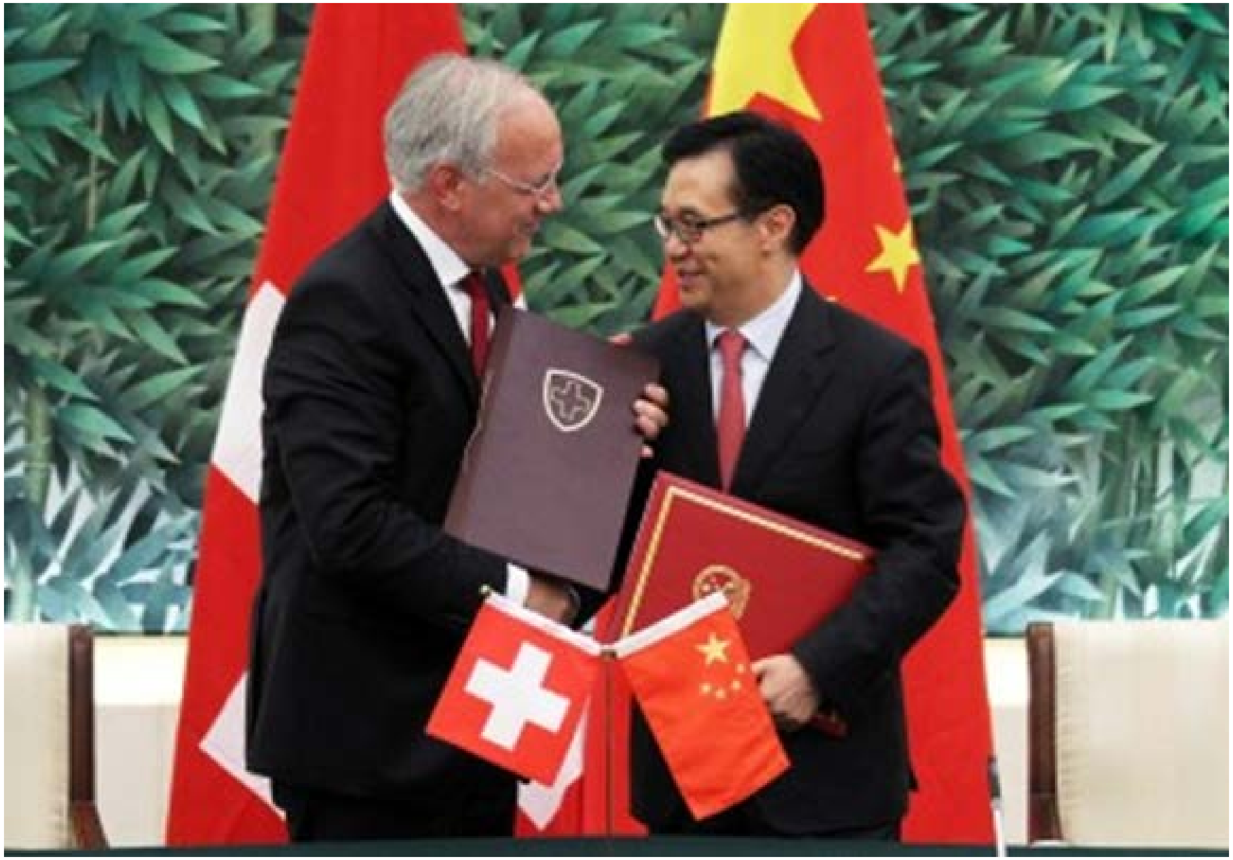
# Free Trade Agreement (FTA)



# Free Trade Agreement (FTA) (Cont'd)

**Key Facts**

- Concluded in 2013 between China and Switzerland
- In force since 1 July 2014
- Switzerland abolishes all customs duties on imports of Chinese industrial goods
- China will abolish or reduce the large majority of its customs duties on imported Swiss industrial goods either when the treaty comes into force or after a transitional period (5, 10 and in some cases 12 or 15 years)

# Free Trade Agreement (FTA) (Cont'd)

**Examples of Custom Duties for Products Exported from Switzerland**

- Eliminated from custom duties from the date of entry into force of the FTA are for example
  - Medical, surgical, dental or veterinary furniture & parts; parts of seats for motor vehicles
  - Certain chemical products

- Eliminated from custom duties within five years are for example
  - Plants used in perfumery
  - Certain devices for motor vehicles

- Eliminated from custom duties within 10 years are for example
  - Racing bicycles
  - Electric wall clocks

- Eliminated from custom duties within 12 years are for example
  - Jewelry & parts thereof of gold, plated with diamond mounted
  - Certain knives

# Free Trade Agreement (FTA) (Cont’d)

**Examples of Custom Duties for Products Exported from Switzerland**

- Eliminated from custom duties within 15 years are for example
  - Television cameras, not for special purposes, broadcast quality

- Not eliminated from custom duties is for example
  - Certain Motorcycles

# Free Trade Agreement (FTA) (Cont'd)

**«Originating Products»**

- The products must be considered as «originating products» to qualify for preferential tariff treatment

- Simply put: «originating products» are products that are
  - Either wholly obtained in the exporting country (e.g. mineral products and other non-living naturally occurring substances extracted or taken from their soil)
  - Or using non-originating materials that have undergone substantial transformation in the exporting country

- Examples of «substantial transformation»
  - For pharmaceutical products (except for waste pharmaceuticals) the maximum percentage of the Value of Non-originating Material (VNM) allowed in relation to the ex-works price of the product is 60%
  - For clocks and watches and parts thereof the maximum VNM can be 40%

- Documentary evidence of origin is to be submitted to the customs authority of the importing country

# Free Trade Agreement (FTA) (Cont'd)

**Concluding Remarks re the FTA from an Economic Perspective**

- Swiss economy has a much better access to the Chinese market → advantages of the Swiss economy over competitors of third countries
- Apart from the FTA with Iceland this is the first FTA of China with a European country
- The FTA confirms that China is in the process of opening its market and does not pursue a protectionist foreign trade policy

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# Double Taxation Agreement (DTA)

- 1991: DTA China / Switzerland entered into force on September 27
- 2010: Start of negotiations China / Switzerland for new DTA
- 2013: Agreement on new DTA China / Switzerland
- 2014: Ratification, new DTA will enter into force by mid-November
- 2015: New DTA China / Switzerland applicable as from January 1

# Double Taxation Agreement (DTA) (Cont'd)

**Important Changes**

- Reduction on withholding tax rates for dividends and royalties, in particular 5% residual tax for dividends from qualifying participations

- Chinese withholding tax on capital gains derived from the sale of shares of a company residing in China

- Adaption to current international standard regarding the exchange of information (OECD)

- Adaption to OECD standard for «Permanent Establishments»

- Operators of international transportation services (ships or aircrafts) being resident in one of the contracting states are exempt from Chinese Business Tax and / or zero rated under Value Added Tax

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# Shanghai Free Trade Zone (FTZ)

- Launched on 29 September 2013

- Covers 29 square kilometers

**China Inbound**

- Suspends administrative approvals for foreign investment within this zone (exception: businesses that are on the «negative list» still require approval)

- However, the FTZ has inter alia no influence on the requirements that apply for
  - Foreign related M&A activity (other than between two Foreign Invested Enterprises)
  - Foreign strategic investment in listed Chinese companies

# Shanghai Free Trade Zone (FTZ) (Cont’d)

**China Outbound**

- The project approval for companies registered in the FTZ wishing to conduct outbound investments is much simpler (converted from a substantive approval process to a mere filing requirement [exceptions]) → Significant time savings

- Creation of free trade accounts (FTA): Funds flowing between FTA and offshore accounts will not be subject to existing restrictions on the movement of funds between China and overseas accounts; FTAs open up the possibility of free transfers of funds for companies in the FTZ, enabling these companies to use their RMB more flexibly for outbound investments

- Companies in the FTZ can process currency exchanges, payments and receipts for direct outbound investments with banks inside the FTZ without further requirements (i.e. no approval from local State Administration of Foreign Exchange [SAFE] required)

- Offshore funding for companies in the FTZ is more accessible, available and attractive

- Companies in the FTZ can provide external guarantees under much simpler conditions

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# Other Recent Legal Developments

**Other Recent Legal Developments**

- On 2 December 2013, the State Council of China issued its new Catalogue of Investment Projects Subject to Governmental Verifications 2013 (2013 Catalogue), which became effective on the same day

- Among other things, the 2013 Catalogue simplifies the verification and registration procedure for outbound investments by Chinese entities

→ Purpose is to reduce and decentralize the verification and registration power and to enhance the enterprises' autonomy on outbound investments

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# Regulatory Framework

A number of key regulatory entities may be required or have a right to review any transaction related to a Chinese seller, buyer or target or a turnover generated in China depending on the nature of the target and its place of incorporation

**Chinese Key Regulators – General Regulators**

- National Development & Reform Commission (NDRC)
  - An agency under the State Council in charge of macroeconomic planning, industrial policy, and overall economic reform
  - Specific functions include
    - Verification of project application reports for new foreign investment projects
    - Drafting of Foreign Investment Guidance Catalogue

- Ministry of Commerce (MOFCOM)
  - Responsible for overall regulation of foreign investment (except for financial institutions)
  - Conducts merger review
  - Leads the national security review
  - Approves establishment and ownership restructuring of FIE (in certain cases)
  - Handles anti-trust, anti-dumping and anti-subsidy matters

# Regulatory Framework (Cont'd)

**Chinese Key Regulators – General Regulators**

- State Administration of Industry and Commerce (SAIC)
  - China's national corporate and business registry
  - Issues all business licenses and renewals
  - Monitors unfair trading practices
  - Key entity in intellectual property enforcement actions

- State-owned Assets Administration Commission (SASAC)
  - Regulator and owner of state-owned assets
  - An agency under the State Council responsible for the supervision of transactions involving state-owned assets
  - Oversees mandatory appraisals for state-owned assets
  - Supervises public announcement and bidding process

# Regulatory Framework (Cont'd)

## Chinese Key Regulators – General Regulators

- State Administration of Foreign Exchange (SAFE)
  - An agency under the State Council and the People's Bank of China in charge of overall administration of inflow and outflow of foreign exchange
  - Permits relatively free flow of payments and receipts on the current account
  - Controls capital account transactions (equity and debt)

# Regulatory Framework (Cont'd)

**Chinese Key Regulators – Sector-specific Regulators**

- China Banking Regulatory Commission (CBRC)
- China Securities Regulatory Commission (CSRC)
- China Insurance Regulatory Commission (CIRC)
- Ministry of Land and Resources (MLR)
- Ministry of Environmental Protection (MEP)

# Regulatory Framework (Cont'd)

**Anti-Monopoly Law**

- Covers three main types of activities
  - Monopoly agreements (cartels) between business operators (NDRC and SAIC)
  - Abuse of dominant market positions by business operators (SAIC)
  - Concentration of business operators that may have the effect of eliminating or restricting competition (MOFCOM)
    - Note: Anti-Monopoly Law supersedes the Chinese M&A Rules with respect to competition issues

# Regulatory Framework (Cont'd)

## Anti-monopoly Enforcement Agency (AMEA)

### National Development and Reform Commission (NDRC)

Enforces the price related rules of the AML (including anti-competitive agreements and abuse of dominance)

### State Administration for Industry and Commerce (SAIC)

Enforces the non-price related rules of the AML and rules against the abuse of administrative powers to restrict competition

### Ministry of Commerce (MOFCOM)

Enforces the merger control regime

# Regulatory Framework (Cont'd)

**Anti-Monopoly Law**

- «Concentration of business operators» refers to
  - Mergers of business operators
  - Acquisition of control by a business operator over other business operators by acquiring their equity or assets, or
  - Acquisition of control by a business operator or ability to exert a decisive influence on other business operators by contract or other means
- «Concentration of business operators» must be notified to MOFCOM if specified thresholds are met

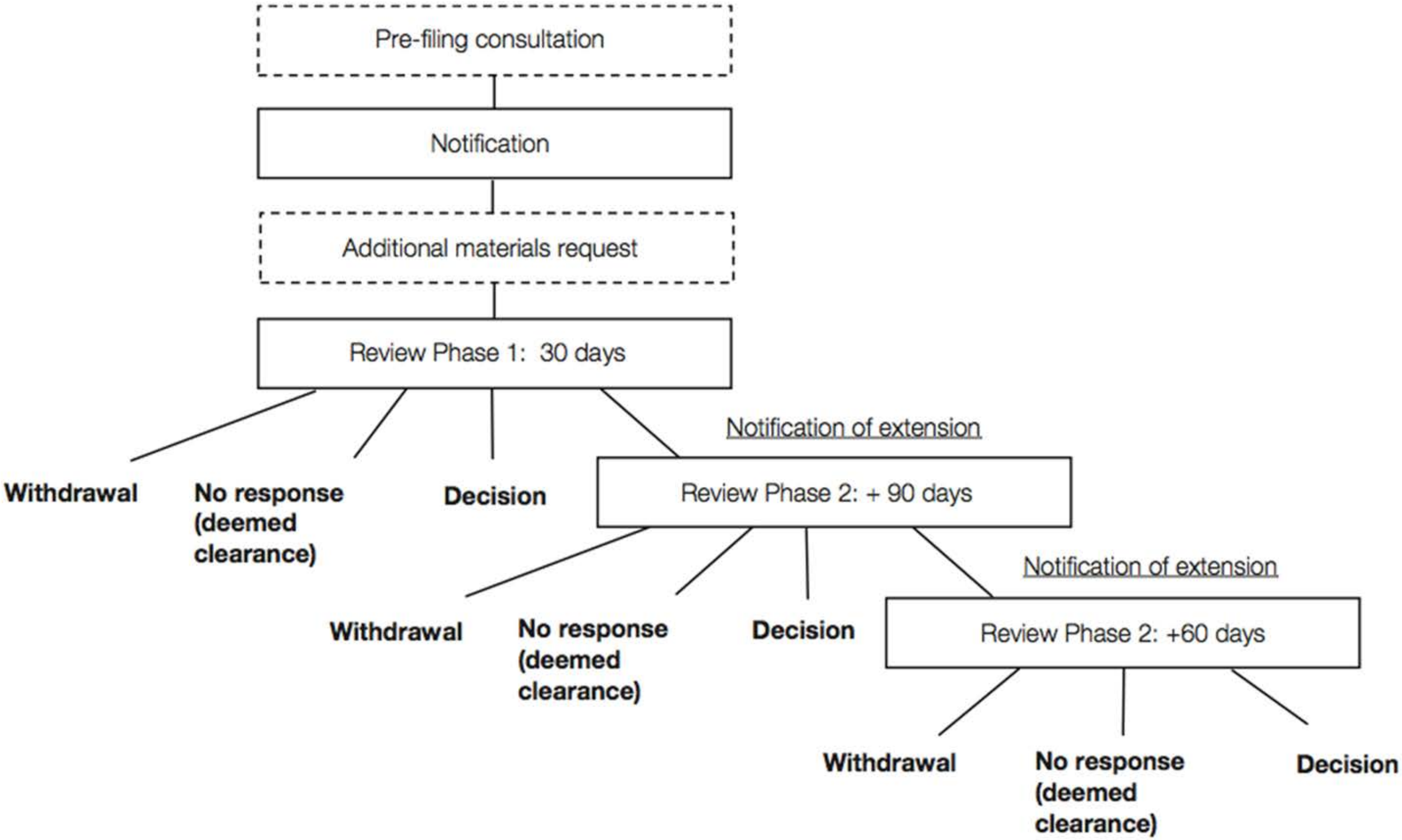
# Regulatory Framework (Cont’d)

**Anti-Monopoly Law**

- MOFCOM notification and review process
  - Phase I: Within 30 days from acceptance of complete filing MOFCOM must
    - Approve the concentration, or
    - Proceed to Phase II (if no notice within 30 days the concentration deemed to have been cleared)
  - Phase II
    - 90 day period to further investigate
    - May be extended by further 60 days under certain conditions (e.g. material change in conditions)

# Regulatory Framework (Cont'd)

## Flowchart of notification and review processes



# Regulatory Framework (Cont'd)

**Pro Memoria: Swiss Anti-Monopoly Review**

- As a general Rule the Swiss Cartel Act states in art. 9
  - Planned concentrations of undertakings must be notified to the Competition Commission before their implementation if in the financial year preceding the concentration
    - a. the undertakings concerned together reported a turnover of at least CHF 2 billion, or a turnover in Switzerland of at least CHF 500 million, and
    - b. at least two of the undertakings concerned each reported a turnover in Switzerland of at least CHF 100 million

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# Chinese Buyers on Swiss or other Non-Chinese Markets

**Challenge: Different Background**

- «Chinese Characteristics»
    - A term most often heard from Chinese
    - No legal term
    - No authoritative definition found
    - No conclusive list of Chinese Characteristics
    - The concept of «Chinese Characteristics» is used to explain requirements that have to be fulfilled but are from a «western» perspective not easily comprehensible

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont’d)

**Challenge: Different Background**

- «Chinese Characteristics»
  - Example: if a superior in China gives instructions, his subordinates carry them out without questioning whether they are right or wrong (in western countries the leader decides and the staff responds with questions and suggestions)
  - Further, the term «Chinese Characteristics» can be found in fixed terms like in: «Socialism with Chinese Characteristics» (the «Chinese Characteristics» refer to elements that are not typical for socialism from a western point of view)

→ The mere understanding that «Chinese Characteristics» are omnipresent and have to be taken into consideration by any activity in the Chinese context helps to be able to better respond to them

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# Chinese Buyers on Swiss or other Non-Chinese Markets

**Examples of Fundamental Chinese Characteristics**

The Experimental Approach

- The use of trial measures, pilot projects, provisional regulations, thus, the «experimental approach» is a Chinese specialty

- This experimental approach is probably the linchpin for the fast economic development of China; it was initiated by Deng Xiaoping‘s statement: «Crossing the river by feeling the stones»

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)


1994: Beloved comrade Xiaoping - The general architect
Jing'aide Xiaoping tongzhi - zong shejishi (敬爱的小平同志 - 总设计师)

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)

**Examples of fundamental Chinese Characteristics**

The Experimental Approach

- «Crossing the river by feeling the stones» means to move ahead with economic reforms slowly and pragmatically
- «Two steps forward, one step back»
- One of the most recent examples of this strategy is the Free Trade Zone in Shanghai

Relation between Legal & Economic Reform

- It is still an illusion to think that, in general, legal reforms proceed economic development
- The legislation is predominantly used to afterwards legitimize an already existing situation

→ Practice precedes policy; policy precedes law

→ As the «Experimental Approach» and the «Relation between Legal and Economic Reform» show, the law in China is much more flexible and provisional than we are used to, so a potential buyer has a different perception of the role that the law plays

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont’d)

**Examples of the Experimental Approach from Practical Experience**

- Short term approach (i.e. ad hoc decisions on next steps) instead of clearly set timetable

- Particularly challenging in a structured auction proceeding

  → open an informal communication channel to get a better understanding of whether the Chinese bidder is up to date in the proceeding

- Involvement of advisors in the last minute

  → insist vis-à-vis the Chinese party to a timely involvement of the advisors so that time related expectations can be met

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)

**Examples of Fundamental Chinese Characteristics**

«Guanxi»

- Definition of «Guanxi»: It literally means «relationships» and includes any type of relationship; in business it stands for the network of relationships between various parties that cooperate together and support one another

- It is about exchanging favors, that are expected to be done on a regular and voluntary basis; it is an important concept to understand if one wants to function effectively in Chinese society

- The right «Guanxi» makes all the difference in bringing your business to success

- It is well worth to invest time and resources to develop and nurture the «Guanxi» to finally achieve a strong network

- Try to establish good «Guanxi» with your immediate Chinese network; they can indirectly link you to new acquaintances and information resources helping you to develop further «Guanxi»

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)

**Examples of fundamental Chinese Characteristics**

«Guanxi»

- Chinese prefer to deal with people they know and trust
- Due to the heavy reliance on a relationship, western companies have to make themselves known to the Chinese before any business can take place
- This relationship is not only between companies but also between individuals at a personal level
- The relationship is an ongoing process
- If the company wants to do more business with the Chinese, it has to maintain the relationship
- Establishing a relationship: (1) treat the Chinese party with decency; (2) the individual or the company has to be trustworthy; (3) being dependable and reliable strengthens the relationship; (4) frequent contacts foster understanding and emotional bonds (the Chinese often feel bound to do business with their friends first)

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)

**Examples of fundamental Chinese Characteristics**

«Guanxi»

- Indirect approach
  - There may be a lot of small talk in the meetings and the really important part is saved for the last two minutes
  - A lot of time is spent on finding common ground and understanding on minor topics
  - It is common to talk about everything but the key issues
  - Should not be underestimated because it is an important aspect of establishing a relationship of trust
  - Issues are often not named directly, but in a cautious and discreet way
  - Further, it is essential to understand not only what has been said but also what they did not say but should have

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont’d)

**Examples of fundamental Chinese Characteristics**

«Guanxi»: Nurturing Guanxi vs. Bribery

- Hold the balance!
- Chinese anti-corruption rules were seen by foreign companies doing business in China as irrelevant in a culture embedded with gift-giving
- Be aware: There has been a recent change in the anti-corruption enforcement landscape in China that has forced foreign companies to reassess
- Examples: the investigations of GlaxoSmithKline (GSK), Eli Lilly, Novartis and Sanofi

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont’d)

**Examples of fundamental Chinese Characteristics**

«Guanxi»: Nurturing Guanxi vs. Bribery

- Foreign companies operating in China should review and re-establish their compliance programs
- They should e.g. conduct regular and thorough audits, establish robust internal controls and strict gift-giving policies
- Foreign companies should be very careful in dealing with Chinese government officials, and shall be alert to any newly-adopted laws regarding gift-giving
- Foreign companies must make sure that a zero tolerance culture regarding corruption is implemented in their Chinese subsidiaries

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont’d)

**Examples of fundamental Chinese Characteristics**

«Guanxi»

- From information of experienced Chinese lawyers and colleagues there is, however, still no profound confidence in the law so that one still relies much more on Guanxi

- Example: Pacta sunt servanda

  - It is an important principle in Chinese culture but in practice it is a basis that predominantly serves the understanding that a relationship of trust between the parties cannot be violated (rather than an article in the formal law)

  - Example: Liquidated damages clause to secure the fulfillment of certain obligations → often seen in the western world; runs contrary to Guanxi

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont’d)

**Examples of fundamental Chinese Characteristics**

«Mianzi»

- It literally means: «reputation; prestige; face»
- Chinese concept of giving «face»; i.e. to praise someone’s reputation in society
- It involves a reciprocal relationship of respect and courtesy
- To get someone to lose face is to denounce status and reputation; it also indicates a loss of confidence and a lack of trust
- Do not voice contrary opinions
- In confronting business situations, aggressive behavior from either party can damage the face of the other party

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont’d)

**Examples of fundamental Chinese Characteristics**

«Mianzi»

- The rule «the client is king» applies in any event with respect to all clients in an attorney-client relationship
  - With respect to a Chinese client, this principle has to be taken even more seriously
  - The attorney should not directly contradict his client if he has a different view; he should rather show alternative approaches to get to the solution
  - Also, advisors should not put themselves into the foreground

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# Chinese Buyers on Swiss or other Non-Chinese Markets

**Dos and Don’ts**

- Negotiation tactics
  - In Chinese culture, it is common that issues, that are discussed and seem closed for a Westerner are often considered still open for a Chinese counterparty
  - This occurs throughout the negotiations until the signing and sometimes even after signing
  - Therefore, keep the key issues mentally open until the very end of the negotiations
  - Keep some room for concessions so that your Chinese counterparty can report some «won points» to its superiors which allows him / her to save the face while making some concessions on other points

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)

**Dos and Don'ts**

- Negotiation tactics
  - One way to get the counterparty into further discussions (even after closing) is the deferment of the payment of parts of the purchase price
  - Purchase price adjustment regime as door opener to re-discuss the terms of the deal even after the closing
  - A seller, if accepting deferment of payments, should therefore seek adequate security for the deferred payments

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont’d)

**Dos and Don’ts**

- Different risk perception
  - Standard clause: «The Financial Statements … fairly represent the financial position of the Target Group…»
  - Chinese parties occasionally require an elevated level of protection. E.g.
    - Representation on collection of accounts receivable (treatment of accounts receivable as cash)
    - Representation on minimum value of net assets as of Closing (even in Locked Box structured M&A transactions)
  - Inspection of purchased factories and facilities on the day of closing

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)

**Dos and Don'ts**

- Chops: make sure that the Chinese party signing the contract uses its chop (company seal); generally, in China a contract with a Chinese company is only valid if it is sealed with the appropriate chop

- Arbitration Clause: China is party of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards

  - With respect to court decisions, there is no agreement between Switzerland and China on the recognition and enforcement

  - It is therefore difficult to have a foreign court decision recognized and enforced in China; chances are better if a foreign arbitration award is given

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)

**Dos and Don'ts**

- Differences in managerial styles and in corporate culture are regarded as a main reason for a failure of outward foreign direct investment

- For that reason the post acquisition phase is of significant importance in the context of Chinese cross-border M&A

- A fundamental challenge that affects the success of the integration process but also of the entire acquisition is: finding the right balance between achieving the necessary level of organizational integration and minimizing the disruptions to the acquired firm's resources and competencies

- A chosen integration model should also consider cultural effects

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)

**Dos and Don'ts**

- Difference between M&A involving Chinese State Owned Enterprises (SOE) and privately owned Chinese firms:
  - SOEs often have complex organizational structures and sophisticated corporate governance mechanisms
  - A top-down approach
  - Little transparency between senior managers and middle managers
  - Additionally, often only the head of the SOE seems to be allowed to talk who generally has no English language skills → communication difficulties make the issue even more severe
  - Privately owned Chinese enterprises are more transparent; they show a fast decision-making process and a stronger willingness to learn

# Chinese Buyers on Swiss or other Non-Chinese Markets (Cont'd)

**Dos and Don'ts**

- Value-added potential from professional firms in the integration phase
  - Even though professional service firms are involved in cross-border M&A transactions, they generally leave after the transactions are closed
  - Their understanding of the institutional environments, especially of local laws and regulations, as well as professional experiences can substantially shorten the institutional distance encountered by Chinese companies
  - Moreover, assessment of local risks by professional firms can help the Chinese companies in making informed business decisions across the globe

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# Swiss Parties Investing in China

**Options of Swiss Parties Investing in China**

Different types of M&A in China

1. Foreign Investor Acquires an Equity Interest in or Assets of an Existing Chinese Company

2. Reinvestment in China by a Foreign Invested Enterprise

3. Transfer of Equity in a Foreign Invested Enterprise

4. Division and Merger of Foreign Invested Enterprises

# Swiss Parties Investing in China (Cont'd)

**Introduction - The three basic Foreign Invested Enterprises (FIE)**

1. Equity Joint Venture
2. Cooperative Joint Venture
3. Wholly Foreign-Owned Enterprises

# Swiss Parties Investing in China (Cont'd)

**Equity Joint Venture**

- Oldest type of FIE (first approved 1980)
- Privately held limited liability company
- Parties contribute capital (in cash or in kind) and take equity interests in proportion to their respective capital contributions
- Managed by a board of directors
- Profits and losses shared in strict proportion to the parties' respective subscribed capital contributions
- By far the most common form of joint venture vehicle
- Parties have pre-emptive rights over each other's equity interest
- Parties have veto rights over transfer of equity interest by other parties

# Swiss Parties Investing in China (Cont'd)

**Cooperative Joint Venture (CJV)**

- Two types of CJV
  - «cooperative» (legal person)
  - «contractual» (non-legal person, like a partnership)

- Non-legal person CJV are very rare; legal person CJV are rare (less common than the EJV)

- Variable arrangements for profit sharing

- Option for a foreign party to recover its capital investment on a priority basis during the term of the Joint Venture

- CJV used in infrastructure projects and venture capital funds

- Parties have pre-emptive rights over each other's equity interest

# Swiss Parties Investing in China (Cont'd)

**Wholly Foreign-Owned Enterprise (WFOE)**

- Most commonly used foreign investment vehicle
- Routinely used where no legal or commercial necessity for a Chinese partner
- Limited liability company solely owned by foreign investor(s)
- Capital contribution in cash or in kind
- Equity interest not subject to pre-emption rights
- Full control over
  - Board of Directors
  - Management
  - Personnel
- Greater control over IP

# Swiss Parties Investing in China (Cont'd)

**Options of Swiss Parties Investing in China**

1. Foreign Investor Acquires an Equity Interest in or Assets of an Existing Chinese Company

- Governed by «*Regulations on Mergers with and Acquisitions of Domestic Enterprises by Foreign Investors*» of 22 June 2009 (M&A Rules)

- This regulation governs both equity and asset acquisitions by offshore investors when target company is a domestic non-FIE

- M&A Rules set out the procedure, scope and limitations on direct foreign M&A activity in China

- Transactions covered by the M&A Rules:
  - Purchase of an equity interest in or shares of a domestic PRC company
  - Subscribing for an increase in capital of a PRC company
  - Establishing a FIE to purchase the assets of a PRC company
  - Purchasing the assets of a PRC company and using these to capitalize a new FIE

# Swiss Parties Investing in China (Cont'd)

**Options of Swiss Parties Investing in China**

1. Foreign Investor Acquires an Equity Interest in or Assets of an Existing Chinese Company

- Approval process for investing in a PRC domestic enterprise:
  - MOFCOM foreign investment approval process applies
  - SASAC approval and filing required if state-owned assets involved
  - Review of market share, market concentration may be necessary if certain thresholds are met (competition review)
  - National security review may also be required if target company is in a specific industry or category

- General Principles
  - Foreign Investment Guidance Catalogue applies
  - Domestic company is converted into an FIE upon completion
  - FIE regulations apply
  - If state-owned assets are involved, then compliance with the relevant rules on the transfer of state owned assets is required
  - Special rules apply when target is a listed company

# Swiss Parties Investing in China (Cont'd)

**Options of Swiss Parties Investing in China**

2. Reinvestment in China by FIE

- Pro memoria

# Swiss Parties Investing in China (Cont'd)

**Options of Swiss Parties Investing in China**

3. Transfer of Equity in a Foreign Invested Enterprise

- Governed by «*Certain Provisions on the Alteration of Investors' Equity in Foreign-Invested Enterprises*» of 28 May 1997

- Typical scenarios
  - Global merger of Multi National Companies with existing (multiple) Chinese FIE
  - Buy-out of Chinese partner and conversion to WFOE
  - Exit China and transfer to another foreign investor

- Subject to MOFCOM / local Commerce Bureau approval

- MOFCOM / local Commerce Bureau issues an Approval Certificate

- Approval Certificate → key document
  - Transfer effective from date issued

# Swiss Parties Investing in China (Cont'd)

**Options of Swiss Parties Investing in China**

3. Transfer of Equity in a Foreign Invested Enterprise

- If state-owned assets are involved, SASAC approval required

- If equity is transferred to Chinese investor(s) the FIE shall be deregistered and a domestic registration carried out

# Swiss Parties Investing in China (Cont’d)

**Options of Swiss Parties Investing in China**

4. Division and Merger of Foreign Invested Enterprises

- Governed by «*Provisions on Merger and Division of Foreign Invested Enterprises*» of 25 September 1999

- Apply to mergers and divisions of EJV, CJV, WFOEs and Foreign Invested Companies Limited by Shares (FICLS)

- Must be approved by MOFCOM / commerce bureau where FIE is located

- Must comply with Foreign Investment Guidance Catalogue

- Merger: surviving company succeeds to debts and rights of dissolved company

- Division: debts to be assumed as per agreement of parties

# Program – Dealing with Chinese Companies – The Swiss Legal Advisor’s Point of View

1. Recent Legal Developments
    a. Free Trade Agreement (FTA) China – Switzerland
    b. Double Taxation Agreement (DTA) China – Switzerland
    c. Shanghai Free Trade Zone
    d. Other Recent Legal Developments
2. M&A with Chinese Parties
    a. Regulatory Framework
    b. Chinese Buyers on Swiss or other Non-Chinese Markets
        – Examples of fundamental Chinese Characteristics
        – Dos and Don’ts
    c. Swiss Parties Investing in China
        – Options of Swiss Parties Investing in China
        – **Information on Protection of Intellectual Property in China**
        – Dos and Don’ts

# Swiss Parties Investing in China

**Information on Protection of Intellectual Property in China**:

- China has a rather bad reputation regarding the protection of intellectual property

- However, the protection is improving
  - More and more litigation cases concerning the protection of IPR are filed
  - Considerable information in English regarding the development of the Chinese IP law (legislation, government politics and judiciary) is nowadays available
  - A fair amount of IPR cases are available in which foreign parties defended their IPR successfully

# Swiss Parties Investing in China (Cont’d)

**Information on Protection of Intellectual Property in China**

- It is still strongly recommended that parties with valuable IPR – apart from registering their IPR – also undertake <u>alternative measures</u>
  - Incorporation of infringement costs into the costs base of their goods
  - Inclusion of protection of IPR in their business plan; implementation of careful control of production, selection of employees who will be in charge of production and limit their exposure to the market once they quit working for the company
  - Implementation of non-compete and confidentiality clauses in contracts with employees, sellers and partners
  - Training and education of employees on issues in intellectual property
  - Careful determination by IPR owners of counterparties to whom they grant a license for distribution; prohibition of their immediate licensees to grant further licenses to other retailers

# Program – Dealing with Chinese Companies – The Swiss Legal Advisor's Point of View

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      – Information on Protection of Intellectual Property in China
      – **Dos and Don'ts**

# Swiss Parties Investing in China

**Dos and Don’ts for M&A in China**

- The fundamentals of the due diligence process are the same in China as anywhere else but are «typically more difficult»

- Common Deal Issues in China:
  - Quality of financial information
  - Weak internal controls / systems: Sometimes even non existent; in the form of «manual controls or punitive controls»
  - Cultural challenges: The company’s understanding of, acceptance of and readiness for due diligence; local management talent; local protectionism
  - Regulatory compliance
  - Intellectual property
  - Ownership structures: Privately owned companies vs. state owned companies
  - Structure the deal well in advance to avoid cash trapping of the purchaser in China in case that he wants to exit the market
  - Tax compliance: tax non-compliance is one of the biggest issues (with respect to privately owned companies it is possible that up to 70% of their sales go through personal bank accounts and are not being reported for tax purposes)

# Swiss Parties Investing in China (Cont’d)

**Dos and Don’ts for M&A in China**

- Common Deal Issues in China:
  - Business practices: For example kickbacks in the supply or distribution channel or facilitation payments to officials
    → one needs to understand the business model and practices in detail
  - In reality, profitability is overstated as the working capital or the liquidity of the company is misstated
  - One often has to look for alternative ways to assess the value of the business; for example by asking
    - what the cost base of the business is
    - how much money is being made (rather than just taking margins of the financial statement)

# Swiss Parties Investing in China (Cont'd)

**Dos and Don'ts for M&A in China**

- Negotiating and Completing the Deal
  - Make sure to go into details – details are very important in China
  - Critical that you know your potential partners since reliance on contracts alone can be difficult → problem of enforcement
  - Good due diligence process is just the beginning; the development of an integration plan well in advance of closing the deal is crucial
    - in case of a wholly owned investment or a majority owned investment,
      → increased ability to change
    - in case of a joint venture or minority investment
      → the implementation of changes is more challenging since you have to rely on the local management

# Typical Clauses in M&A Transactions (Cont'd)

| Topic | Western SPAs | Chinese SPAs |
|---|---|---|
| Deal Structure | Auctions: Fixed price / locked box often seen<br><br>Other transactions: Closing accounts also very common; Earn outs: less common | Fixed Price common<br><br>Price adjustment clauses may be impracticable for SOEs<br><br>Price adjustments / Earn Outs / deferred payments not uncommon for POEs |
| Conditions Precedent | Generally limited to regulatory and third party consents<br><br>MAC not unusual, often quantified<br><br>Sometimes accuracy of representations and compliance with covenants added | Very limited for SOEs<br><br>MAC unusual |
| Regulatory Approvals | "Hell or high water" clauses often seen in auctions | No "hell or high water" clauses |

# Typical Clauses in M&A Transactions (Cont'd)

| Topic | Western SPAs | Chinese SPAs |
|---|---|---|
| Reps and Warranties | For PE Sellers: limited<br>Strategic Sellers: broader | Generally limited; increased level of protection occasionally sought on specific matters |
| Reps and Warranties repeated at Closing | At least core warranties are repeated at closing | Often not repeated |
| Disclosure | Entire data room | Specific disclosure |
| Financial limitations | 10-25% purchase price;<br>100% for title | Higher or sometimes even no caps |
| Duration of Representations | At least one audit cycle, often 18 months | Longer, sometimes unlimited |

# Thank you!

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