

INSIDE THE MINDS™

BEST PRACTICES FOR MERGERS AND ACQUISITIONS IN CHINA

LEADING LAWYERS ON IDENTIFYING INVESTMENT
OPPORTUNITIES, NAVIGATING COMPLIANCE REQUIREMENTS,
AND ADVISING CLIENTS ON TRANSACTIONS

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The Anti-Monopoly Law
and Other New Regulations
Impacting Chinese
M&A Deals

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Recent Trends in Chinese M&A Deals

The mergers and/or acquisitions (M&A) area in China during the year 2010 was very active. A total of 1,798 deals involving mergers and acquisitions were completed, a 6.14 percent increase over 2009. The deals involved US\$8.2 billion, a 62.57 percent increase over the number of deals in 2009.

About twenty industries participated in these M&A deals. The top three industries were manufacturing (382 deals), energy (258 deals), and real estate (229 deals), respectively occupying 24 percent, 17 percent, and 15 percent of the total number of deals.

Changing Laws for M&A Deals in China

The laws for mergers and acquisitions in China have not changed very much in recent times, but supplementary rules have been issued to make them more enforceable. China's Anti-Monopoly Law (AML), which became effective on August 1, 2008, is China's first comprehensive antitrust law. It includes the three pillars of most modern antitrust laws, with rules on (1) "monopoly agreements," cartels, and other multiparty anticompetitive conduct; (2) "abuse of dominant market position," dealing with unilateral conduct; and (3) "concentrations," which covers mergers and acquisitions and joint ventures.

Soon after China's AML took effect, a new mandatory regime for the review of mergers, acquisitions, and joint ventures was introduced. In the past few years, guidelines and rules have been published that clarify the Ministry of Commerce's (MOFCOM) procedures for enforcing the new regime, and MOFCOM's decisions have been published in three high-profile cases. They are the InBev/Anheuser-Busch case, the Coca-Cola/Huiyuan case, and Mitsubishi/Lucite case.

Consider the Coca-Cola/Huiyuan case, for example. The Coca-Cola Co. announced its proposed acquisition of China Huiyuan Juice Group Ltd. on September 3, 2008, and filed its pre-merger notification on September 18. The statutory review period finally began on November 20, two months after the initial filing. On March 18, 2009, MOFCOM blocked Coca-Cola's planned acquisition of Huiyuan in the first prohibition decision adopted

under the AML. In its decision, MOFCOM identified the following adverse impacts from the proposed transaction:

Coca-Cola would be able to leverage its dominant position in the carbonated soft-drink market to the fruit-juice drink market, eliminating and restricting competition from current juice manufacturers and in turn, damaging the lawful interests of juice consumers. Although the decision did not indicate how Coca-Cola could leverage its position in carbonated soft drinks, MOFCOM's press release referred to the possibility that Coca-Cola could engage in tying, bundling, or other forms of exclusive dealing. Coca-Cola's market power in the juice market would be markedly enhanced by controlling two famous juice brands, Meizhiyuan (Minute Maid) and Huiyuan. The transaction would significantly raise entry barriers for potential competitors in the fruit-juice drink market.

The transaction would reduce the space available to domestic small and medium-sized juice manufacturers and negatively affect the ability of domestic enterprises to compete and innovate independently in the fruit-juice drink market.

The transaction would have adverse impacts on the competitive landscape in China's fruit-juice drink market and the sustainable and healthy development of the domestic juice industry.

According to the AML, the Anti-Monopoly Commission (AMC) will conduct an examination on a concentration and its impact on national security in accordance with this law. According to Article 20 of the AML, a concentration refers to the following circumstances: (1) the merger of business operators; (2) acquiring control over other business operators by virtue of acquiring their equities or assets; or (3) acquiring control over other business operators or the possibility of exercising a decisive influence on other business operators by virtue of contact or any other means. Where a concentration reaches the threshold of declaration stipulated by the State Council, a declaration must be lodged in advance with the Anti-Monopoly Authority under the State Council, otherwise the concentration will not be implemented.

Article 31 of the AML provides that "where a foreign investor merges and acquires a domestic enterprise or participates in a concentration by other

means, if state security is involved, besides the examination on the concentration in accordance with this Law, the examination on national security shall also be conducted in accordance with the relevant State provisions.” However, the relevant state provisions had never come into being until February 3, 2011, when the general office of the State Council, or China’s Cabinet, decided to establish a ministerial joint committee for undertaking national safety reviews of foreign mergers and acquisitions of domestic firms.

The rules were publicized in the form of a circular. According to the circular, the check involves foreign mergers and acquisitions of Chinese military industrial enterprises and supporting firms, companies near “major and sensitive military facilities,” and others relevant to the national defense of China. Reviews will also be needed for foreign mergers and acquisitions of Chinese enterprises in sectors involving national security that may be controlled by foreign investors after being acquired, such as major agricultural products, major energy and resources, infrastructure, transportation services, key technologies, and equipment manufacturers. The review assesses the merger’s or acquisition’s influence on national defense, productivity, supply capacity of service, the national economy, the order of public life, as well as on the research and development of the country’s key technologies. The review committee, overseen by the State Council, will be led by the National Development and Reform Commission and the Ministry of Commerce (MOC). Foreign investors looking to acquire domestic firms should file applications to the MOC. According to the notice, the MOC could suspend mergers or acquisitions by foreign investors that may have a significant impact on the national security upon demand of the committee. The Ministry may also take other measures, including stake or asset transfers, to eliminate the impact of a merger or acquisition on China’s national security. The rules, dated February 3, 2011, will take effect in thirty days after the issuance of the circular.

Key Features of Successful M&A Deals in China

With increasing attention being drawn to the protection of the energy industry in China, energy enterprises represented by the China National Petroleum Corporation (CNPC), China Petroleum & Chemical Corporation (Sinopec), and China National Offshore Oil Corporation, have speeded up

their rate of mergers and acquisitions of offshore energy enterprises. Of the ten biggest deals in 2010, five were carried out by Chinese energy enterprises involving the mergers and acquisitions of offshore enterprises. In October 2010, state-owned Sinopec concluded a deal to buy 40 percent of Repsol SA's (Repsol REP.BMAD) Brazilian subsidiary, Respol Brazil, for \$7.1 billion.

There have also been a substantial number of mergers and acquisitions of Chinese enterprises in the food and drug industries involving foreign enterprises, which has aroused great public concern in China over the safety of these domestic industries. By the end 2010, the French drug maker Sanofi-Aventis SA has agreed to buy Genzyme Corp. in a sweetened all-cash \$20.1 billion deal that ends months of corporate haggling and positions Sanofi at the forefront of the market in lucrative drugs for rare genetic disorders.

Chinese Agencies Responsible for Regulating M&A Deals

China's AML establishes a multilevel and multifaceted enforcement structure under the State Council, the chief executive body. The AMC (1) researches and drafts competition policy; (2) organizes and publishes studies on the state of competition; (3) develops guidelines; (4) coordinates enforcement; and (5) fulfills assignments from the State Council.

The AML specifies that the State Council will designate Anti-Monopoly Enforcement Authorities (AMEA) that will be responsible for enforcement in this area. The State Council designated three existing agencies to share enforcement responsibilities: (a) the Ministry of Commerce, (b) the State Administration for Industry & Commerce (SAIC), and (c) the National Development & Reform Commission (NDRC). MOFCOM is the secretariat for the AMC as well as the AMEA responsible for M&A control and enforcing the AML against anticompetitive conduct in international trade.

New Regulatory Measures Affecting Upcoming M&A Trends in China

In China, M&A activity is closely aligned with the government's policy priorities. In 2010, the Chinese government showed its determination to continue to restructure its industries and economy by publishing a series of

regulations with regard to the creation of a friendlier regulatory environment for M&A activities, strengthening environmental protection, restructuring state-owned enterprises to encourage them to grow into global companies, and encouraging the development of high-tech companies. Because of these policy objectives and other factors, we may expect to see the following M&A trends in China:

Friendlier Regulatory Environment for M&A Deals: On April 6, 2010, the Chinese State Council issued a notice with regard to improving the use of foreign investment. The notice encourages foreign investors to participate in the reorganization and restructuring of domestic enterprises through equity investments and mergers and acquisitions. According to the notice, the Chinese government will amend the Catalogue for the Guidance of Foreign Investment Industries to encourage foreign investments in the high-end manufacturing, high-tech, new energy, energy-efficiency, and environmental protection sectors. As a result, these sectors will be hot areas for M&A activity.

Sale of Obsolete Production Capacity: The recently published "Notice of the State Council on Further Strengthening the Elimination of Backward Production Capacities" sets ambitious environmental targets and requires certain energy-consuming sectors such as the coal, coke, ferroalloy, iron and steel, buildings, lighting, and transportation industries to phase out enterprises with obsolete production capacity by the end of 2012. With targets to ensure achievement of these objectives, the governmental authorities will encourage the sale or restructure of such enterprises with obsolete production capacity. Therefore, in the following two years, China is likely to see a high volume of M&A deals in these industries.

Restructure of State-Owned Enterprises: In accordance with the opinion of the State-Owned Assets Supervision and Administration Council (SASAC), the number of state-owned enterprises (SOEs) owned by SASAC was supposed to be reduced to one hundred by the end of 2010, and the number of SOEs would be further reduced to eighty by 2020. At the end of 2010, however, the number of state-owned enterprises was still over 120, far from the objective of the SASAC. These SOEs tend to be complex organizations with many business units. It is anticipated that the split-up and reorganization of these companies will lead to a surge of M&A activity in the coming years.

Encouragement of High-Tech Company Development: The Chinese government has published numerous laws and regulations encouraging the development of high-tech companies. High-tech companies enjoy 15 percent preferential tax treatment in addition to favorable financing and employee recruiting policies. Large high-tech companies tend to boost the growth of smaller, local high-tech companies. As these local high-tech companies tend to develop, their narrowly focused but value-added products often fill in gaps in product lines of many multinationals and other large companies. As more and more large enterprises fill out their product offerings in China and elsewhere, these smaller high-tech companies will be attractive targets for acquisition by larger companies looking to increase their market share in China.

Recent Challenges for M&A Deals in China

The most important challenges for M&A deals in China at the present time involve evaluating potential Chinese targets. There are often disagreements over management control. Owners are often reluctant to give up control, especially to foreigners.

The second challenge is the inability to establish clear title to assets, or improper licensing of those assets. Tracking the ownership and chain of title to assets is sometimes very difficult in China for several reasons, including the incomplete assets registration systems.

The third challenge is the high expectations of value on the part of Chinese sellers, attributable to the booming Chinese stock market.

The fourth challenge is the unreliability of financial statements, lax regulatory compliance, and ambiguity with respect to tax payments that create significant contingent liabilities. As a result, there tends to be a large gap between what a buyer is willing to pay and a seller is willing to accept. A related challenge that foreign investors may encounter is the practice on the part of many Chinese business owners of holding ownership in the names of other people, usually family members or friends. As a result, there are often verbal agreements as to the ownership of an enterprise. In addition, documents filed with the regulatory authorities may conflict with company records. Therefore, an acquirer must spend a significant amount of time and effort to conduct financial and legal due diligence to sort these issues out before jumping into a deal.

The fifth challenge is the new Rules by the State Council regarding the national safety review in M&A deals. Enterprises intending to acquire Chinese businesses in some industries may find that their deal is rejected based on a national safety review. For example, this could occur in cases such as foreign mergers and acquisitions of Chinese military industry enterprises and supporting firms, companies near “major and sensitive military facilities,” and others relevant to national defense of China. Challenges may also occur in cases where foreign businesses intend to do mergers and acquisitions of Chinese enterprises in sectors involving national security that may be controlled by foreign investors after being acquired, such as major agricultural products, major energy and resources, infrastructure, transportation services, key technologies and equipment manufacturers.

In order to overcome these challenges, it is advised that foreign investors intending to acquire Chinese enterprises should spend sufficient time and energy in due diligence on the target companies before making any final decisions. They should have a good Chinese partner or agency familiar with the Chinese market to assist them with their deals. In addition, foreign acquirers should also have a deep understanding of the new Rules by the State Council regarding the national safety review in M&A deals.

Final Thoughts

Comparatively speaking, China is a new and special M&A market, and foreign investors will be faced with many problems, difficulties, and challenges they may never have met in the more developed Western markets, particularly since China promulgated its first Anti-Monopoly Law in 2008. It will prove worthwhile for foreign investors in China to spend more time and effort in order to have a better understanding of both the Chinese market and its rules concerning M&A deals before they finally decide to close any such deals.

Key Takeaways

- The Chinese market provides foreign investors with both opportunities and challenges. It is advisable that foreign investors intending to enter the Chinese market should spend more time and effort in order to have a better understanding of both the Chinese market and its rules concerning M&A deals.

- Due diligence on the target companies should be carried out before making any final decisions.
- A good Chinese partner or agency familiar with the Chinese market can be very helpful in M&A deals.

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He has advised international clients in all major economic sectors on investment, trade and dispute resolution matters in China since 1987. He is the longest serving foreign lawyer with Chinese legal firms (since 1989). Mr. Lehman is one of the best-known "China-hands" after sixteen years in Beijing and Shanghai, in association with major international and Chinese firms. He, along with Chinese nationals, established Lehman, Lee & Xu, one of China's leading full-service professional service firms with six offices throughout greater China. He has been selected by his peers as one of the best advisors in mergers and acquisitions, China banking, intellectual property, finance, foreign direct investment, and infrastructure and corporate commercial.

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