The China premium

Why western M&A contracts won't work in China

Alibaba's acquisition of Yahoo China in 2005 was one of the highest profile M&A deals in China in recent years, and Alibaba's chairman, Jack Ma, is justifiably revered as a visionary and well-respected business leader in China. So in late 2005, when Jack Ma spoke at a seminar in Beijing to talk about the Yahoo China deal, the large audience of Chinese business leaders listened with rapt attention as he berated Yahoo's financial advisers and legal counsel, accusing them of taking a simple deal and making it too complex. "You may know how to buy a company," he reportedly told Yahoo's lawyers, "but you do not know how to sell one." The Chinese audience erupted in thunderous applause.

Jack Ma is no one's fool. When he scolded Yahoo's advisers, it might well be that he did so as a calculated tactical negotiating ploy. But his comments reflect a common sentiment among Chinese managers – that western lawyers always unnecessarily complicate simple deals.

This sentiment reflects Chinese business managers' general lack of familiarity with typical M&A structures and practices as well as the broader cultural differences between western and Chinese business people, where the Chinese consistently place greater emphasis on the personal relationship between main individuals within the respective entities than on the specific wording of the contract. As the managers of one Chinese target said to a European multinational acquirer: "You have done hundreds of these deals before. This is the only cross-border M&A deal we have done or will ever do in our careers." Unfortunately, with few exceptions, the Chinese seller's local financial and legal advisers might also not have done a cross-border M&A deal before (and if they do have the experience, there is no guarantee that their client will take their advice).

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So as a practical matter, there often is not a common language for negotiation of a cross-border M&A deal. This is not just a question of translation between Chinese and English; it is a question of the lack of a shared conceptual and value framework.

As such, foreign acquirers of Chinese targets need to be prepared to pay a premium for China deals, not necessarily a purchase price premium (although valuation issues are a potential sticking point, particularly with state-owned shares and assets), but a *China premium* in the shape of increased time, effort and resources needed to negotiate and conclude the deal. Great progress has been made over the past 10 years in China, but in most cases foreign acquirers still have to be prepared to invest substantial additional time (including the time of their professional advisers) to educate the seller, the target, their advisers and relevant government officials on commonly accepted international cross-border M&A practices.

Due diligence: the first hurdle

The problems and misunderstandings can start at the due diligence stage. The concept of due diligence is still new to many companies in the PRC. Chinese sellers are often reluctant to fully disclose information about the target company before the final documents have been signed, and might, unless pushed, only make partial or incomplete disclosures. Acquirers need to understand why this is the case: in some instances the in-house lawyer or mid-level manager involved at the working level is unsure about what level of clearance they have to disclose, or are worried about disclosing documents that are sensitive or contain company business secrets. Often they don't wish to trouble management at a higher level with a request for guidance, and they might see non-disclosure as the safest way to proceed from their career perspective. Recent articles in the official Chinese press taking the angle that foreign companies could still achieve their objectives (even if their M&A deal in China falls through) by obtaining the Chinese target's business secrets certainly do not help.

In one project we were involved in, the Chinese seller initially refused to provide a copy of the target's articles of association (or any other documents except its business licence) on the grounds that these constituted a state secret. Another public company target initially was only willing to provide copies of annual reports.

More fundamentally, many Chinese companies do not have a centralized repository to keep, track and manage corporate documents, including licences, contracts, accounting books and records. To the extent they are maintained, these documents are often spread across multiple departments and entities within the group of companies. Inter-company transactions within a group are sometimes not documented at all.

So due diligence is an exercise in patience and education. In most deals you should start with the expectation that no data room containing all of the documents requested on the due diligence checklist will be set up. Often only a handful of documents will be provided at the initial stage, and the acquirer's lawyers will need to spend several days or even weeks on site explaining the process and rationale for due diligence and cajoling the seller and target into providing the requested documents. Once all available documents have been provided, management interviews will be critical to fill in the all-too-predictable information gaps.

There is an emerging trend, still in the early stages of development, for Chinese sellers to engage international financial and legal advisers up front, particularly in connection with auction sales of quality assets. But even in these cases, responsibility for organizing the data room is often left to the company and the local legal advisers. Due to the lack of familiarity with the international norms in this area, coupled with concerns about disclosure of business secrets, highly restrictive data room policies are often applied that add to the timeline and costs of a transaction, for example, a ban on even the most basic corporate documents being removed from the data room, meaning all documents must be hand-transcribed. The overall trend and direction in this area is positive, and the number of sophisticated, overseas-trained local lawyers and managers is increasing, particularly in the more developed cities of Beijing and Shanghai. However confidence in the due diligence concept is fragile, as isolated but highly publicized cases of bad faith dealing can easily undermine progress in this regard.

Localizing standard agreement terms

Jack Ma's response to the acquisition agreement drafted by Yahoo's lawyers is typical of responses of Chinese sellers generally – in their view acquisition agreements are too long and too complex. (Of course Alibaba was the acquirer in that deal. It is possible that Yahoo's lawyers were only too happy to streamline the acquisition agreement because most agreement terms are designed to protect the buyer.)

If someone as sophisticated as Jack Ma has this response, then it can only be expected that most Chinese sellers react the same way to the typical foreign acquisition agreement. Acquisition agreements in domestic M&A

deals (still a new phenomenon in the China domestic market) are usually simple in their structure, often addressing only the most basic transaction points, such as the number of shares and the price to be paid.

As a practical matter, the parties will have to take a middle ground position that balances the divergent expectations of the parties. Typically, the initial draft acquisition contract should be simplified, streamlined and localized as much as possible without compromising the acquirer's rights. A standard template or precedent acquisition agreement used in other jurisdictions might not work in the Chinese context, or might not be comprehensible when translated directly into written Chinese. This is particularly the case with long, complex clauses drafted in legalese, which challenge the skills of even the best translators and articulate concepts such as warranties and indemnities, neither of which have an express legal basis in Chinese law. The Chinese legal drafting style is also different. Short, straightforward sentence structures are the norm, as multiple sub-clauses are difficult to express in good legal Chinese. However, the foreign acquirer should still insist that the agreement include all standard clauses typically found in an international acquisition agreement. The Chinese seller will probably complain that even the streamlined version is too long and complex, but the foreign buyer need not compromise on matters of style and presentation to the point of forfeiting core substantive rights.

Not all Chinese sellers will automatically resist standard acquisition agreements. The founding shareholders of many private Chinese start-up companies are often foreign-educated entrepreneurs who are comfortable with standard international agreements or are simply focused on obtaining new funding (as opposed to reading the fine print). So in some cases the seller will sign whatever is put in front of them so long as the main commercial terms match what was negotiated at the term sheet stage and, at the other end of the scale, in some cases the seller will negotiate every last word.

There is an emerging category of more sophisticated Chinese sellers who are ready and willing to negotiate with foreign buyers using a more international-style acquisition agreement as the base, but this is still the exception rather than the rule.

The devil in the details

The disconnects between foreign buyers and Chinese sellers are most clearly illustrated in the discussion of more detailed provisions of typical acquisition agreements. The Chinese legal environment also imposes certain constraints on standard acquisition agreement clauses.

Conditions precedent

Chinese sellers, particularly state-owned enterprise (SOE) sellers, often are willing to agree only to a single condition precedent (CP) to completion – receipt of all necessary government approvals for the transaction. Other standard CPs typically meet strong resistance, because the Chinese seller sees them as granting the foreign buyer a separate contractual right to exit the deal after the government approvals have been obtained. In many cases, the transaction documents will be effective on approval as a matter of law, so any conditions precedent other than government approval might need to be satisfied before submitting the transaction documents for approval. Conditions subsequent to reverse out of a transaction that has become legally effective are particularly tricky because they depend on the relevant approval authority's willingness to reverse its decision, which is never a given.

However, again with patience and persistence, the Chinese seller generally can be persuaded to accept appropriate additional CPs, which for the most part are matters within their control, such as no breach of representations and warranties, or no breach of covenants. As would be expected, the negotiations become more difficult in respect of CPs relating to pre-completion confirmatory due diligence (which is recommended in many cases given the lengthy government approval timelines for many acquisitions) and material adverse change (MAC) clauses.

Payment terms

The Chinese seller might ask for an advance payment of a portion of the purchase price upon signing the final acquisition agreements. Advance payments are common in local practice in domestic deals, allowing the seller to complete necessary restructuring, repay debt or to resettle redundant employees. However, the foreign buyer can (and should) resist this request in cross-border deals.

Great care should be taken to match the timing of payment to transfer of the equity interests in a share deal. This seems self-evident in principle, but in practice is not always as simple as one might hope. In some situations, for example in an acquisition of non-tradable shares in a B-share listed company (legal person shares in B-share companies have not yet been converted into tradable shares as is the case with A-share companies), certain final approvals for the share transfer can only be issued after payment is deposited in a settlement bank account.

Ideally, the deal agreements can be structured to ensure that any advance payment is made only after all substantive CPs have been satisfied.

Lastly, Chinese law requires that the purchase price be paid in full in a single instalment within three months after the new business licence is issued or, with approval, in instalments of initial payments at least 60% of the purchase price within six months after the business licence is issued and the balance within 12 months of the issuance date. This means that retention funds and holdbacks for breach of warranties are challenging, and has clear implications for the next issue – escrow.

> **"One seller we encountered simply deleted all the warranties in a document on the basis that they were unfair"**

Escrow

Most Chinese sellers are not familiar with escrow arrangements either in an M&A transaction or in other contexts, and so instinctively resist this concept. This reluctance is reinforced by government policies seeking to protect state interests and maximize the return on the sale of state assets – in some cases the State-Owned Assets Supervision and Administration Commission (Sasac) will dictate that proceeds from the sale of state-owned shares and assets be remitted upstream from the SOE seller to government coffers.

The mandatory acquisition purchase price payment terms above also present concerns in structuring an escrow with a term that matches the period of validity of the representations and warranties. It is not clear that opening the escrow account in the name of the seller will satisfy these timing requirements in all cases. The location of the escrow account is also a matter that requires attention. Foreign buyers prefer that the escrow account be opened offshore due to foreign exchange remittance control concerns, but Chinese sellers cannot always easily open an offshore account.

Lastly, finding a Chinese bank to act as escrow agent presents its own set of issues. Escrow services are new in the market and not all local banks will be aware of what is involved or will be sophisticated enough to administer the account in a satisfactory manner. If the escrow account is opened onshore with a Chinese bank, foreign buyers might have a strong preference for the Beijing or Shanghai branch of one of the big four Chinese banks, but the seller might prefer to deal with the local branch of its long-term relationship bank.

Alternatives to escrows (such as cash collateral accounts, bank guarantees, and share pledges) all present their own sets of practical issues. Each option will have to be evaluated carefully in the context of the particular transaction.

Price adjustments

Given the extended period required for government approvals (four to 12 months depending on the nature of the transaction and the number of approvals required), price

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adjustment mechanisms based on accounts prepared as of the completion date are highly recommended. However, parties to a cross-border acquisition of a Chinese target might not be fully free to adjust the purchase price by mutual agreement. In the case of the acquisition of state-owned shares or assets, the seller would have to engage a duly qualified asset appraisal firm up front to appraise the value of the shares or assets, and that appraisal result must be submitted to Sasac for approval and registration. By law, the purchase price must not be more than 10% below the appraisal result, except with special approval. Once that sale price is approved, it is almost chiselled in stone – local Sasac officials will have already reported that value up the chain to Beijing and will be responsible for ensuring that this amount is received. So post-completion adjustments to the price for state assets are problematic.

Representations and warranties

Not fully understanding the concept, rationale and consequences of representations and warranties, Chinese parties might either refuse to give any representations and warranties other than those relating to simple facts such as due establishment of the target, or, on the other hand, might easily agree to extensive, onerous representations and warranties that are inconsistent with the results of due diligence. Neither situation should be acceptable to, or give comfort to, the foreign buyer.

Patient explanation of the purpose and necessity of representations and warranties will be required. One seller we encountered simply deleted all the warranties in a document on the basis that he thought they were unfair. Most Chinese sellers will not be familiar with the standard tools at the disposal of sellers to limit the scope of the warranties across the board (such as knowledge and materiality limitations, and disclosure), so often each warranty is looked at individually, which is time-consuming. The concept of disclosure against specific warranties is not well understood in general. Even if provision for a disclosure letter were made in an M&A acquisition agreement, few sellers would be able to provide disclosures targeted against specific warranties, as would be seen in a typical international M&A deal. An obvious inconsistency between the due diligence outcome and the warranties, known to the seller but with no corresponding disclosure provides a warning light that the disclosure concept might not have been understood or explained sufficiently. Again, some Chinese sellers are becoming more sophisticated and will know how to use these tools to push back on certain reps and warranties. So getting pushback in the right places can give more comfort to a foreign buyer, because it means that the seller is thinking about what obligations it can and cannot perform, making it more likely that those assumed will be performed.

Indemnities

There is no concept of indemnity in the Chinese legal system that is equivalent to the common law concept. While it is commonly understood that the parties' agreement in this regard will be enforced under the general doctrine of freedom of contract, it is not clear how clauses will be interpreted and will work under Chinese law. For example, Chinese law imposes a foresight test on all losses in order for them to be recoverable (such that the losses must have been foreseen, or ought to have been foreseen at the time the party in breach entered into the contract) which would not work as a straight dollar-for-dollar clause.

One strategy that used to work in China M&A was to have the transaction documents governed by foreign law. This is generally permitted in cases where there is a foreign element, including the situation where there is one non-Chinese party to the acquisition agreement, subject to certain exceptions, for example, joint ventures and natural resource exploitation contracts where Chinese governing law is mandatory or where laws and regulations provide otherwise. In this way, one could attempt to ensure that an indemnity would be interpreted and applied under US, English or Hong Kong common law principles. However the new China Regulations on Foreign Investors Merging with or Acquiring Domestic Enterprises, effective September 8 2006 (the M&A Regulations) impose Chinese law both on asset and share deals involving domestic capital targets. Another provision (the exact scope of which is unclear) provides that even in acquisitions involving foreign-invested targets (which are primarily regulated by a separate set of legal rules), where the other rules are silent, the M&A Regulations apply "by reference," tacitly imposing Chinese law as the governing law of these transactions. Recent Supreme Court documents take the same approach, while the recently revised Takeover Code (also effective September 8 2006) goes one step further and imposes China as the location for dispute resolution as well.

The overall impact is that M&A has essentially been added to the list of carve-outs from the general rule on adopting foreign governing law, and this strategy is no longer available in the case of acquisition agreements governed by the M&A Regulations, although it might be available for other ancillary documents, such as technology and trademark licences. However, it is clear that foreign law cannot be used to contract out of compliance with provisions of Chinese law that are mandatory in nature, so this is only a limited scope mitigation strategy.

In many cases, the Chinese seller, out of a misplaced sense that the obligations of the parties should be seen as being balanced and fair, and ignoring the inherent imbalance in the risks, which are disproportionately borne by the buyer (we had one case where legal counsel for the Chinese party insisted on having the same numerical numbers of warranties on either side so as to achieve this), might ask for corresponding indemnities for buyer breaches. This can be resisted generally, but in some cases the buyer can offer limited indemnities, typically in the form of general liability for contract breaches not exceeding its liability under applicable law in any event.

Chinese sellers are already accustomed to agreeing to total liability caps equal to the total purchase price and are not predisposed to trying to negotiate that down in the M&A context. Where buy-side indemnities are given, much lower caps can (and should) be negotiated. These liability caps should generally be enforceable on the basis of freedom of contract, but need to be seen in the Chinese legal context, where no specific provision of law expressly supports liability caps. Chinese law is not a system where the fact that something is not prohibited inherently means it is permitted (and there is no system of binding judicial precedent to provide a consistent basis and practice on enforcement). The statutory provisions on exclusion of liability clauses in Chinese law, which are quite broad, also need to be considered in this context. Any purported exclusion of liability for personal injury or for property damage caused by wilful acts or gross negligence is invalid by law.

Pre-closing covenants

The typical Chinese response is to reject pre-closing covenants out of hand, at least initially. Once persuaded of the necessity of these covenants, they not only will seek to limit the buyer's consent and approval rights but also will often seek to form a joint management team for the interim period. This in turn leads to issues as to allocation of related risks and responsibilities and possible impacts on the effectiveness of related representations and warranties given by the seller in respect of this interim period.

Deadlock

This is an issue where the cultural divide really stands out. The western approach is generally to take the contract (and ultimately the courts or arbitration) as the primary means of resolving disputes between the parties, but most Chinese business people see the contract as being more of a framework and a starting point of a personal relationship, which is far more significant than the words in the contract. In the Chinese business culture,

disputes should first be resolved by friendly consultations based on these personal relationships. Litigation is a last resort. The Chinese counterpart generally sees any suggestion at the initial courtship stage of possible future discord or disharmony as embarrassing or inappropriate. The typical reaction on seeing a deadlock resolution clause in a contract is "Why are you discussing our divorce before we have even got married?"

It is important to explain to the Chinese seller that it is in both parties' interests to be able to move forward if relationships do break down. Although negotiations on this point are often emotive and difficult, most Chinese parties do see that there is a business need for such mechanisms. Deadlocks are far more likely to occur in a Chinese joint venture than in many other jurisdictions (even if not split 50-50) because entrenched minority protections in the Sino-foreign joint venture laws and regulations state that, where the Chinese party has board representation, it can block resolutions that must be passed unanimously by law (including fundamental business decisions such as increases in capital, changes to the articles of association, merger with another entity or dissolution and liquidation of the joint venture). Also, because government approval is required for transfers of equity interests in foreign invested enterprises at the China level to be valid, the usual palette of deadlock resolution machinery will not necessarily work in the same way as in common law jurisdictions. For example, puts and calls will only be enforceable if the relevant government approval is forthcoming. Where a partial acquisition is contemplated, these post-acquisition joint venture partnering issues need to be factored in.

Managing the negotiation process

Chinese sellers might put much more weight on, and feel a heightened sense of obligation not to deviate too much from, the provisions of the letter of intent (LOI) or memorandum of understanding (MOU), than their western counterparts. This is because this document typically will have gone through some sort of preliminary internal and government approval process, out of sight of the foreign acquirer. Consequently, it is always good practice for the parties to outline the main issues in the LOI or MOU, but preferably avoiding creating any hostages to fortune. If detailed enough, the LOI or MOU provides a basis for the structure of the deal and the terms to be included in the final acquisition agreements. If entered into without enough thought by the foreign acquirer (on the basis it is technically non-binding), it can turn into a millstone around the foreign investor's neck, as subsequent changes will be seen by the Chinese seller as backtracking.

The foreign buyer should always insist on controlling how the main transaction documents are drafted to retain more control of the overall process, and to save time and costs. Ideally, the foreign buyer should agree up front which language version will be used in the negotiation process. Contemporaneous translation (both of negotiations and interim contract drafts) is burdensome, but in most cases is an unavoidable necessity.

Even if the decision-makers are present at the negotiation table, the parties should prepare meeting minutes to confirm what has been agreed at the end of each negotiation session. This will minimize backtracking and be consistent with local practices and preferences. At the later stages of the negotiation process, the foreign buyer might need to ensure that the Chinese party commits to having all main team members and advisers available on a dedicated basis throughout the rest of the deal (in which case the foreign buyer must do the same).

Expect the unexpected

Each China deal is an adventure. You should expect the unexpected and not come armed with any preconceptions based on western ways of doing business as to how a China deal is done. You should expect that you will have to spend a disproportionate amount of time and resources on issues that you could never anticipate based on experience with M&A deals outside of China. Patience, understanding and flexibility are the watchwords.

Sometimes, the rabbit is pulled out of the hat, not by the parties, but rather by third parties, such as the government approval authorities. For example, the central or local government might promulgate a new policy that is not in line with the existing law, or China's international commitments, or the rules of a higher authority that they are supposed to follow. Local authorities might issue certain rules to address a specific issue in their particular area, such as employment resettlement, that are not found elsewhere. In other cases, local approval authorities might inform the seller that certain agreed terms have to be removed, watered down or obfuscated to avoid the attention or wrath of higher government authorities. Invariably there will be a protracted debate about what goes into the documents submitted for government approval and what does not.

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In China, there is almost always a way to work around these obstacles, but the solution is not always elegant or easy to explain to the foreign buyer's senior management and board of directors. If experienced advisers are on board, they can act as a sounding board and provide a straight response as to the risks and the options, and check through independent channels whether there is a genuine legal or regulatory basis for unexpected requirements. Foreign acquirers in China not only need an appetite for the risks inherent in an acquisition in China, but also an ability to achieve a level of comfort with some additional level of ambiguity in drafting in certain circumstances, so long as the main commercial and legal points are not abandoned.

Keep an open mind

Foreign companies (whether multinationals or small to mid-sized enterprises) cannot afford to ignore China. It is a big market and the entire global supply chain has moved or is moving there. Standard greenfield foreign direct investment structures remain popular, but the trend towards direct acquisitions of existing local companies is gathering momentum as more sectors open up post-WTO, and more local companies develop viable and attractive businesses. Foreign companies need to be in the position of an informed buyer and know not only how to identify a suitable target, but also how to close the deal in a way that can be sold to their head office. Understanding the counterparty's expectations and frame of reference is the first step. Doing business in China does not mean that you have to lower your guard or your standards, or blindly accept that only the Chinese seller knows how China works, but it does mean that you need to be flexible enough to meet new sets of challenges, almost on a daily basis. Many of the patterns of behaviour that come up in China practice cannot be judged as right or wrong. They are simply a response based on different cultural and business norms and expectations. Closing the culture and expectation gaps will enable you to make informed choices when you meet the inevitable bumps in the road on the way to closing the deal.

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By Robert Lewis and Andrew McGinty of Lovells