

PRACTICE GUIDES

China M&A

Second Edition

Contributing editor

David P Willard



China M&A

Practice Guide

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Practice Guide

Second Edition

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Risk Analysis: M&A Transactions in China

Jerry Hansen, Weng Yee Ng, Michelle Zhao and Kezia Hardingham¹

From the day Deng Xiaoping opened China's doors to the international market, China has, and continues to be, one of the countries that holds great appeal to foreign investors. This interest has given rise to an exponential increase in the volume of M&A transactions involving Chinese companies, some of which have been great success stories while others have been never-ending challenges for the investors. There are good reasons why foreign investors are not put off by those challenges, and continue to strengthen their presence in China – access to a massive market, lower cost of labour and rapid technological advances, to name a few.

China has long been associated with high levels of corruption and is one of the BRIC (Brazil, Russia, India and China) countries often cited as having higher risk. Frequently, at least in the compliance context, the term 'BRIC countries' carries the negative connotation of being high risk. However, the BRIC countries are, as we all appreciate, the economies that are anticipated to represent nearly half of global GDP by 2050. So, there are clearly good reasons to seek to invest in these countries, even with the risks and challenges associated with such investments.

Across the globe, the covid-19 pandemic has had a significant impact on M&A transactions. While the number of China's outbound M&A deals contracted during this time, foreign M&A deals into China have skyrocketed to surpass the number of outbound deals.² Furthermore, the outlook for inbound M&A deals during the second half of 2020 remains resilient, driven by foreign appetite for Chinese assets as well as large corporates' and private equity firms' shopping for a bargain.

In general, the most common risks are those related to the political or regulatory climate in China, including the United States' continual trade negotiations and the current alleged risks related to certain Chinese companies (eg, Huawei, TikTok and Alibaba); the documented historical bribery and corruption risks; and financial risks relating to the ability to move monies in and out of China; among other operational risks. This chapter takes a closer look at several specific risks

1 Jerry Hansen is a partner, Weng Yee Ng is a director and Michelle Zhao and Kezia Hardingham are managers at Forensic Risk Alliance Ltd.

2 www.bakermckenzie.com/en/newsroom/2020/06/china-outbound-manda.

within these general categories of carrying out M&A deals in China. Notwithstanding these risks, with awareness of these challenges, and proper planning to address them, investing in China can be a viable and rewarding option for companies and investors seeking to expand into Asia.

Key considerations and risks of doing deals and investing in China

Bribery and corruption risks

The 2019 Transparency International Corruption Perceptions Index gave China a score of 41 out of 100,³ sharing that rank with Benin, Ghana, India and Morocco, and just above countries such as Burkina Faso, Guyana, Indonesia and Kuwait. Despite the crackdown on 'tigers and flies', an anti-corruption campaign initiated by President Xi in 2012, it appears that corruption continues to be endemic within the country and remains a key concern for potential investors.

Reasons cited for bribery and corruption risks in China include a restricted press or media, ambiguous interpretation of the law, importance of the state and burdensome bureaucracy. Another reason for high levels of bribery and corruption risks in China that has been mentioned in many academic papers and the media is *guanxi* (loosely translated as relationships). This practice of giving and receiving gifts and favours could very easily slide towards more nefarious facilitation payments or bribes.

For Chinese companies operating under enforced extraterritorial laws, such as the Foreign Corrupt Practices Act (FCPA) or the UK Bribery Act, this is especially problematic. Several FCPA settlements have involved an allegation of bribery and corruption occurring in China. Recent examples include the following.

- In February 2020, Ohio-based pharmaceutical company Cardinal Health agreed to pay in excess of US\$8 million to resolve charges that it violated the books, records and internal accounting controls provisions of the FCPA in connection with its operations in China.
- In June 2020, global pharmaceutical and healthcare company, Novartis AG, and its former subsidiary, Alcon, agreed to pay over US\$340 million to resolve SEC and DOJ charges in relation to improper practices in multiple jurisdictions, including violations arising from the lack of internal accounting controls in China.⁴

Prior to 2018, there were concerns that Chinese multinational companies may have had the advantage over foreign investors who were subject to stricter and wider-ranging anti-bribery and corruption laws. In early 2018, China passed an amendment to the Anti-Unfair Competition Law explicitly prohibiting indirect bribery through third parties.⁵ This Law, if enforced, has the potential to level the playing field somewhat for foreign investors.

3 A score of 0 means highly corrupt, while a score of 100 means very clean. 'Corruption Perceptions Index 2019', Transparency International, www.transparency.org/en/cpi/2019/results, accessed 27 August 2020.

4 'SEC Charges Novartis AG with FCPA Violations', US Securities and Exchange Commission, www.sec.gov/news/press-release/2020-144.

5 'Third-Party Screening and Monitoring Are Critical for Health Care and Life Science Companies', *Lexology*, www.lexology.com/library/detail.aspx?g=34185af8-46f3-4b2c-b54d-7e7402aa485f, accessed 26 September 2019.

Announced in 2014, the implementation of China's social credit system (SCS) is planned to be substantially complete by the end of 2020.⁶ The SCS has been the subject of many international news articles because of its controversial features. The system aims to give individuals a score as a judgement of their behaviour and trustworthiness (for example, traffic violations would result in a deduction in points and donating to charity would result in an increase).⁷ This system applies to companies as well as individuals, and is expected to have a significant impact on compliance matters. For example, a low credit score may result in companies being black-listed, which is a key element for consideration when investing in Chinese companies and when conducting third-party due diligence. A low credit score or penalties for a low score may also result in denial of licences, permits, credit facilities or eligibility to participate in certain public procurement tenders.

Recent regulatory changes and a focus by the government on anti-corruption are signals that things are changing. Notwithstanding such changes, investors need to remain keenly aware of corruption risks when investing in China, both before and after any merger or acquisition.

Successor liability risk

The overarching corruption risk in the M&A context is successor liability. Successor liability is the risk of acquiring a company that is covered by the FCPA, or other similar anti-corruption regulations, and has already violated those laws, thereby exposing the acquirer to potential liability based on pre-acquisition acts over which it had no control.

A few examples of corruption risk arising from successor liability include the following.

- Pfizer's settlement with the DOJ and the SEC in 2012 encompassed FCPA violations by its subsidiary Wyeth relating to bribes paid to government doctors in China that primarily occurred prior to Pfizer's acquisition of Wyeth in 2009.⁸
- In July 2016, Johnson Controls settled with the SEC for over US\$14 million for allegations that a wholly owned Chinese subsidiary had used ghost suppliers to make improper payments in China to employees of government-owned shipyards, shipowners and other third parties to obtain and retain business.⁹ That Chinese subsidiary was acquired by Johnson Controls in 2005 as part of its acquisition of York International.

Such potential risks to transaction parties deserve significant attention. The DOJ and SEC's Resource Guide to the US FCPA (Guide), originally released in November 2012 and subsequently updated in July 2020, emphasises the importance of pre-closing due diligence and post-closing

6 Eric Carlson and Helen Hwang, 'China's Social Credit System applies to companies and impacts compliance', *The FCPA Blog*, 5 September 2019, www.fcpablog.com/blog/2019/9/5/chinas-social-credit-system-applies-to-companies-and-impacts.html.

7 Nicole Kobie, 'The complicated truth about China's social credit system', *Wired*, www.wired.co.uk/article/china-social-credit-system-explained, accessed 26 September 2019.

8 'FCPA Liability in M&A: lessons from Pfizer settlements', *Lexology*, www.lexology.com/library/detail.aspx?g=37e21b8f-bfdc-47ac-9289-f84e6cc53660, accessed 11 September 2019.

9 Richard L Cassin, 'Johnson Controls pays SEC \$14 million to settle China bribe case, receives DOJ Pilot Program declination', *The FCPA Blog*, 12 July 2016, www.fcpablog.com/blog/2016/7/12/johnson-controls-pays-sec-14-million-to-settle-china-bribe-c.html.

integration of the target into the acquirer's compliance and internal control programmes. The Guide advocates:

- a risk-based analysis of the target's customer base;
- an analysis of the target's go-to-market strategy and approach;
- a review of the target's legal, accounting and compliance departments;
- a review of the target's sales and financial data, customer contracts and third-party agreements (including high-risk third parties such as distributors and agents); and
- interviews with target management, not limited to those in charge of legal, sales and audit functions.¹⁰

At the same time, companies need to be aware of some of the more significant challenges encountered when performing due diligence, including:

- level of access to (the target's) books and records;
- low quality or limited availability of publicly available information;
- fragmented information sources;
- discrepancies between company information at state and national levels;
- disorganised, incomplete and unreliable information; and
- press restrictions.

Third-party due diligence

Third-party risks in China include all of the most common risks – bribery, corruption, fraud, money laundering and conflict of interest – all of which necessitate appropriate due diligence to safeguard transaction parties and companies.

A few examples of corruption risks arising from third parties are provided below. Based on these very few examples, it is clear that performing sufficient due diligence around third parties prior to making an acquisition or investment is worth the cost.

- In 2012, Morgan Stanley's real estate and fund advisory practice colluded with a former chairman of a Chinese state-owned enterprise (SOE), where US\$1.8 million worth of finder's fees were owed to third parties in exchange for business brought to Morgan Stanley.¹¹
- In 2014, the UK Serious Fraud Office started a formal criminal investigation into GlaxoSmithKline's operations in China and several other countries where allegations included the engagement of third-party vendors to disguise illegal payments.¹²

10 'A Resource Guide to the U.S. Foreign Corrupt Practices Act', Criminal Division of the US Department of Justice and the Enforcement Division of the US Securities and Exchange Commission, www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf, accessed 27 August 2020.

11 Mark Jenkins, Sunny Chu and Christopher Meadors, 'FCPA compliance in China', *Fraud Magazine*, March 2014, www.fraud-magazine.com/article.aspx?id=4294982094.

12 'GlaxoSmithKline PLC investigation', UK Serious Fraud Office press release, 27 May 2014, www.sfo.gov.uk/2014/05/27/glaxosmithkline-plc-investigation/.

- In 2018, United Technologies Corporation agreed with the SEC to pay US\$13.9 million for violations by its subsidiaries Pratt & Whitney, which paid commissions to a third-party agent via a joint venture to sell jet engines to state-owned airlines, and Otis Elevator Company, which paid a kickback to an official of a state-owned bank to win a contract to install lifts in one of the bank's branches. There were also accusations of improperly funding leisure travel for foreign officials from China and other countries.¹³
- In 2018, Michigan-based medical device manufacturer Stryker agreed to pay the SEC US\$7.8 million for FCPA violations, including employment of unauthorised sub-distributors.¹⁴
- In 2019, Sweden-based telecommunications company Telefonaktiebolaget Ericsson was charged with engaging in a large-scale bribery scheme involving the use of sham consultants to secretly channel funds to government officials in multiple countries, including China.¹⁵
- In 2019, US-based retailer Walmart agreed to pay a combined amount of over US\$282 million as a result of failure to operate a sufficiently robust anti-corruption compliance programme for more than a decade, thereby allowing its subsidiaries, including in China, to employ third-party intermediaries who paid foreign government officials without reasonable assurances of compliance with the FCPA.¹⁶

Considerations regarding the types of M&A transactions

The common M&A transaction structures for foreign investors in China include majority-equity subsidiaries, joint ventures and minority investments where the risk and the decision-making rights lie with local management. These different types of investments bring different challenges to the foreign investor in China.

Where one investor might think that having a minority stake (ie, where the foreign investor does not make operational decisions) in the company is the least risky form of investment, another may believe that a majority equity interest is the safest as he or she is able to dictate how the entity is run. The ultimate selection is up to the specific investor, but each type of investment has its own set of risks and benefits of which investors should be aware.

13 'United Technologies Charged with Violating FCPA', US Securities and Exchange Commission press release 2018-188, 12 September 2018, www.sec.gov/news/press-release/2018-188.

14 'SEC Charges Stryker a Second Time for FCPA Violation', US Securities and Exchange Commission press release 2018-222, 28 September 2018, www.sec.gov/news/press-release/2018-222.

15 'SEC Charges Multinational Telecommunications Company with FCPA Violations', US Securities and Exchange Commission press release 2019-254, 6 December 2019, www.sec.gov/news/press-release/2019-254.

16 'Walmart Charged with FCPA Violations', US Securities and Exchange Commission press release 2019-102, 20 June 2019, www.sec.gov/news/press-release/2019-102.

Below are some potential risks, grouped by type of investment.

Minority investments	Joint ventures	Majority-owned subsidiaries
<ul style="list-style-type: none"> • Inability to make operational decisions • Inability to deploy consistent group-level policies and procedures • No access to operational matters and financial results; for example, financial results are limited to published audited financial statements only • No access to books and records, and no right to audit 	<p>Depending on the terms and conditions set forth within the shareholders' agreement, there may be:</p> <ul style="list-style-type: none"> • some restrictions on decision-making at the operational level • some limitation on deployment of consistent group-level policies and procedures • limited visibility of the operations and financial results • no or limited access to books and records • no or limited right to audit 	<p>Although the foreign holding company is able to deploy aligned policies and procedures, there may be:</p> <ul style="list-style-type: none"> • challenges in repatriation of funds from the entity • entire responsibility for any violations of laws and regulations by the entity

These risks are further heightened when the majority equity owner or the joint venture partner is an SOE because access to books and records, financial information and operational details are more often than not significantly restricted.

Data privacy regulations

A part of any M&A deal is access to data and this necessary access continues after the investment is made. Access to data brings its own set of risks and concerns both inside and outside China. The Personal Information Security Specification is China's national standard on the collection and processing of personal information. The May 2018 Personal Information Security Specification states clearly that consent is the preferred basis for data collection; however, two of the most significant grounds for processing data under the General Data Protection Regulation (GDPR), other than consent, are disallowed in China: (i) performance of a contract, but excluding legitimate interests; and (ii) the removal of 'contract performance'.¹⁷ As a result, US or EU companies with operations in China will not be able to process data belonging to their Chinese employees solely on the basis that they have an employment contract with said employees.

Corruption risks could also be intertwined with GDPR issues. For example, in 2018, Dun & Bradstreet entered into a US\$8.1 million FCPA settlement with the SEC based on self-disclosed violations by two of the company's China-based subsidiaries following the SEC's allegation that the company made illicit payments to obtain data on Chinese citizens via third-party agents.¹⁸ With multiple data privacy regulations to be considered and significant focus on enforcement of these new regulations, investors must be knowledgeable in this area to avoid unintentional violations that bring serious consequences.

17 Griffen Thorne, 'GDPR Meets its Match . . . in China', *China Law Blog*, 14 July 2019, www.chinalawblog.com/2019/07/gdpr-meets-its-match-in-china.html.

18 'SEC Charges Dun & Bradstreet with FCPA Violations', US Securities and Exchange Commission, Administrative Proceeding, File No. 3-18446, 23 April 2018, www.sec.gov/enforce/34-83088-s.

Other considerations and risks of doing deals in China

Political climate

When investing in a foreign country, the political climate is an important consideration because regulatory changes can potentially impact business strategy, such as operational changes and changes in laws regarding foreign ownership of businesses, among others. China is a communist country with a relatively stable political situation on the whole. The Communist Party of China (CCP) has been the sole ruling party since 1949, and there are no signs of this changing in the near future. Under President Xi Jinping's leadership, the government has gradually moved away from collective leadership and consensus-based decision making towards a centralisation of power.

Nonetheless, there are undoubtedly signs of nervousness at the top levels of government. In January 2019, during a meeting with provincial leaders of the CCP, President Xi stressed the importance of maintaining political stability and warned that slowing economic growth could result in political vulnerability. During that meeting, President Xi also put the Minister of Public Security in charge of curbing any protests that may arise.¹⁹ Anti-government protests in Hong Kong, which started in June 2019, triggered by discussions on the introduction of the extradition bill that was subsequently withdrawn, have clearly changed the political landscape and dynamics, not just between Hong Kong and Beijing, but also globally. This continues to be an area where changes are occurring on a daily basis, and investors should be closely watching these events.

China has, over the years, become less protectionist; however, when compared to many other countries, there is a higher degree of state involvement to navigate (implicit as well as explicit). Government intervention on grounds of national interests and penalties to countries that are not in alignment with government foreign policy are but two examples of state involvement in doing business in China. However, not all involvement by the Chinese government is unfavourable to investors as is evidenced by new laws being established that should, if effective, have a positive impact on foreign investment in China.

One example is the Foreign Investment Law, effective since January 2020, which aims to improve the foreign investment framework in China and give further protection to foreign investors. This Law replaces the three primary laws regulating foreign-invested enterprises (FIEs) in China: the Law on Sino-Foreign Equity Joint Ventures, the Law on Wholly Foreign-Owned Enterprises and the Law on Sino-Foreign Cooperative Joint Ventures.²⁰

The Foreign Investment Law in China provides FIEs with the following:

- equal application of compulsory national standards;
- requirement for testing in courts before judgment on actual force of protections can be made (for example, intellectual property protections);

19 Juliette Genevaz, 'Sources of Political Stress in China', War on the Rocks, 14 May 2019, www.warontherocks.com/2019/05/sources-of-political-stress-in-china/; 'China's Xi Warns Party of "Serious Dangers" as Risks Mount', Bloomberg.com, 22 January 2019, www.bloomberg.com/news/articles/2019-01-21/china-s-xi-calls-for-political-stability-as-economic-risks-mount.

20 'China: Foreign Investment Law Passed', *Global Legal Monitor*, Library of Congress, 30 May 2019, www.loc.gov/law/foreign-news/article/china-foreign-investment-law-passed/.

- free foreign exchange settlement of capital injection, capital revenue, asset disposal income, profits, royalty fees, compensation, indemnity, etc; and
- no expropriation of foreign investments, except, under special circumstances, the state may expropriate or requisition the investment of foreign investors for the public interest.

Impact of trade war, sanctions and anti-competition

The tit-for-tat trade war between the US and China spiralled to new heights in 2020, but there are no indications that it has dampened enthusiasm for M&A deals in China, as seen by ExxonMobil's US\$10 billion investment in April 2020 in the construction of a chemical complex in the south-east province of Guangdong. Notwithstanding such deals, risks and concerns related to the global political climate remain relevant. Qualcomm, for example, waited almost two years after striking the US\$44 billion deal for NXP Semiconductors, a Dutch global semiconductor manufacturer, only to have to walk away from the deal in 2018 after failing to secure Chinese regulatory approval as a result of a Sino-US trade spat.²¹

This type of government involvement in M&A deals is not unusual for many countries, especially in the case of antitrust concerns. However, historically there has been a higher incidence of government intervention in China of the nature seen in the *Qualcomm/NXP* deal. Trade wars and sanctions only increase the likelihood of such involvement, although these are normally temporary interruptions to deals.

In May 2019, China enacted the 'unreliable entity list' (UEL), which includes individuals and foreign entities whose 'non-commercial' acts are detrimental to the interests of Chinese companies. This move was mainly in response to the US's move to add Huawei to the US Entity List. In May 2020, in retaliation against Washington's move to block shipments of semiconductors to Huawei Technologies, China threatened to include a number of US companies on the UEL, launch investigations and impose restrictions on a number of large US corporations, including Apple.²² More recently, in August 2020, the deal between the Chinese parent company of TikTok, ByteDance, and suitors for the app's US operations was further thrown off track as the Ministry of Commerce updated China's 'forbidden and restricted technology exports' by adding 23 items to the restricted list, including 'personalised information recommendation services based on data analysis, algorithms and artificial intelligence'. This recent rule change is a reminder that China could still have a say in M&A transactions by foreign investors.

Foreign currency transactions and profit repatriation from China

Foreign currency and China's own currency, the Chinese yuan, are regulated by China's State Administration of Foreign Exchange (SAFE). To maintain control over the fluctuation of its own currency, SAFE imposed strict restrictions on the flow of monies both in and out of China. This tight restriction, imposed on individuals as well as companies, makes it a difficult and lengthy

21 Michael Martina and Stephen Nellis, 'Qualcomm ends \$44 billion NXP bid after failing to win China approval', Reuters, 25 July 2018, www.reuters.com/article/us-nxp-semicondtrs-m-a-qualcomm/qualcomm-ends-44-billion-nxp-bid-after-failing-to-win-china-approval-idUSKBN1KF193.

22 'China ready to put Apple, other U.S. companies in "unreliable entity list"', Reuters, 15 May 2020, www.reuters.com/article/us-usa-huawei-tech-china/china-ready-to-put-apple-other-u-s-companies-in-unreliable-entity-list-global-times-idUSKBN22R1X2.

process for monies to be remitted from China. This should obviously be an important consideration for investors and dealmakers.

Currently, the most common methods of repatriating monies out of China include:

- remitting profits as dividends to the holding company;
- remitting inter-company fees to the holding company and companies within the group; and
- extending inter-company loans to companies within the group.²³

In 2016, following the weakening of the yuan, the cap for large companies to withdraw funds out of China with minimal documentation was reduced from US\$50 million to US\$5 million.²⁴ This reduction has made it more challenging to move money out of China.

In addition, investors should be aware that SAFE has stepped up measures to stem capital outflows more generally, especially since the yuan declined to an eight-year low against the US dollar and foreign reserves fell to around US\$3 trillion in 2016. Since 2016, China's monetary authority has been imposing a series of policies to stem capital outflows, discouraging companies from engaging in non-core outbound investments and tightening inspections on citizens exchanging foreign currency. Furthermore, to show that they mean business, SAFE named and shamed five companies in 2017, alleging contract and invoice forgery to facilitate the remittance of over US\$200 million offshore from 2015 to 2017.²⁵

National secret considerations

When dealing with SOEs or handling information that may be deemed state secrets by the authorities, there is a fuzzy line between what constitutes SOE trade secrets versus state secrets. Investments and transactions involving SOEs are therefore faced with the additional challenge of needing to seek confirmation that the information they are obtaining, and possibly removing, from China is not a state secret, to avoid any violations of China's State Secrets Law. Classified information is supposed to be marked as such. If it is not marked and the person who has provided the information has failed to clarify that the information is classified, the risk remains that both the party receiving the information and the party providing it may face prosecution.²⁶

While the Classification Provisions of 2014, which were primarily derived from US legal concepts, provided more rigorous procedures and standards for secrecy officials, they do not change the standards that courts apply when adjudicating a state secrecy claim. The bottom line is that the State Secrecy Bureau and its counterparts retain maximum flexibility in terms of the interpretation of what constitutes state secrets. Therefore, care needs to be exercised when

23 Dezan Shira & Associates, 'Profit Repatriation from China', China Briefing, 31 July 2019, www.china-briefing.com/news/profit-repatriation-from-china/.

24 James T Areddy and Lingling Wei, 'Foreign Companies Face New Clampdown for Getting Money out of China', *The Wall Street Journal*, 1 December 2016, www.wsj.com/articles/foreign-companies-face-new-clampdown-for-getting-money-out-of-china-1480604271.

25 Jane Cai, 'Revealed: the sneaky ways Chinese are moving money across the border', *South China Morning Post*, 29 May 2017, www.scmp.com/news/china/economy/article/2096032/chinas-watchdog-tracks-underground-cash-trail.

26 Mitchell A Silk and Jillian S Ashley, 'Understanding China's State Secrets Laws', *China Business Review*, 1 January 2011, www.chinabusinessreview.com/understanding-chinas-state-secrets-laws/.

handling data and information as a violation of the State Secrets Law could lead to imprisonment or criminal detention.

Environmental risks

The number of companies in China accused of violating environmental regulations is on the rise. China has promised zero tolerance for firms guilty of offences such as illegal waste disposal and tampering with monitoring equipment. China's Environmental Protection Law, in force since 2015, allows authorities to fine individuals and companies on a daily basis until the issue is rectified and allows regulators the authority to file criminal charges.

A focus on environmental issues is not unique to China. However, it does highlight that sufficient due diligence relating to potential environmental issues should be performed to mitigate possible erosion of deal value.

Money laundering risks

In April 2019, the Financial Action Task Force published a report on China's anti-money laundering and counter-terrorist financing system. The report states that China has a strong understanding of money laundering and terrorist financing risks but should focus more on the laundering of proceeds of crime and increase the range of sources used for its national risk assessment.²⁷ In June 2019, China's central bank issued a statement that it would strengthen cooperation with other countries to curb cross-border money laundering activities,²⁸ and in May 2020, China's National People's Congress stated that it had plans to revise the law governing the People's Bank of China (PBOC or Central Bank) as part of its legislative tasks earmarked for 2020.

2020 has seen a surge in penalties handed out to financial institutions by the PBOC, including the following.

- In February 2020, China Everbright Bank, China Minsheng Banking Corporation and brokerage Huatai Securities were fined 23.6 million yuan, 18.2 million yuan and 10.1 million yuan, respectively, for failure to adequately prevent money laundering.²⁹
- In April 2020, the PBOC imposed another record-high penalty of 116 million yuan on payment service company Allscore Payment Services for its involvement in facilitating overseas gambling.³⁰

27 'China's measures to combat money laundering and terrorist financing', FATF, APG and EAG, [www.fatf-gafi.org/fr/publications/evaluationsmutuelles/documents/mer-china-2019.html?hf=10&b=0&s=desc\(fatf_releasedate\)](http://www.fatf-gafi.org/fr/publications/evaluationsmutuelles/documents/mer-china-2019.html?hf=10&b=0&s=desc(fatf_releasedate)).

28 'China central bank to strengthen anti-money laundering cooperation overseas', Reuters, 19 June 2019, <https://uk.reuters.com/article/uk-europe-moneylaundering-china/china-central-bank-to-strengthen-anti-money-laundering-cooperation-overseas-idUKKCN1TK0VH>.

29 Peng Qinqin and Guo Yingzhe, 'Central Bank Ramps Up Punishment for Money Laundering', Caixin Global, 17 February 2020, www.caixinglobal.com/2020-02-17/central-bank-ramps-up-punishment-for-money-laundering-101516449.html.

30 Nathan Huang, 'PBOC to Step Up Efforts in Fighting Money Laundering', Redpulse China, 13 June 2020, www.redpulse.com/china/20200613/pboc-to-step-up-efforts-in-fighting-money-laundering-6132d4e97a.

- In June 2020, the Chinese unit of BNP Paribas was fined US\$378,200 for failure to perform client identity verification and report large and suspicious transactions. Three of its senior executives of its Chinese subsidiary were also fined in connection with the violations.³¹

As enforcement and penalties continue to increase in frequency and magnitude, foreign companies operating in China need to ensure that appropriate know-your-customer procedures and controls are in place, specifically around politically exposed persons, to mitigate money laundering risks.

Nepotism and princeling hires

As mentioned above, *guanxi* is an important element in doing business in China. It is the cultural norm to help one another as part of relationship building through gestures such as referring potential job opportunities to friends and families, even if they are not qualified for the job, as a repayment or reward for bringing in deals and business. The cases mentioned below illustrate the frequency of FCPA violations involving the hiring of 'princelings' (ie, the children of government officials and other favoured referrals who did not qualify for the position they were given), demonstrating the extent to which the practice is deeply rooted within the country.

- In 2016, San Diego-based Qualcomm paid US\$7.5 million to settle charges for FCPA violation through the hiring of relatives of Chinese officials who were decision makers in the selection of the company's products.³²
- Also in 2016, JPMorgan Chase paid US\$264 million for engaging in a systematic bribery scheme by hiring 'princelings'.³³ Three years later, in 2019, JPMorgan's former Asia investment banking vice chair faced charges for offering employment to the son of a customer as a reward for favouring JPMorgan Securities Asia Pacific.
- In 2018, Credit Suisse paid a settlement of US\$77 million relating to claims that the lender's Hong Kong unit attempted to win banking business by offering jobs to friends and family of Chinese officials.³⁴
- More recently, in 2019, Deutsche Bank agreed to pay over US\$16 million for FCPA violations relating to the hiring of underqualified relatives of Chinese and Russian government officials in return for business deals.³⁵

31 'BNP Paribas Chinese Unit Fined for Anti-Money Laundering Violations', RiskScreen, 2 June 2020, www.riskscreen.com/kyc360/news/bnp-paribas-chinese-unit-fined-for-anti-money-laundering-violations/.

32 'SEC: Qualcomm Hired Relatives of Chinese Officials to Obtain Business', US Securities and Exchange Commission press release 2016-36, 1 March 2016, www.sec.gov/news/pressrelease/2016-36.html.

33 'JPMorgan Chase Paying \$264 million to Settle FCPA Charges', US Securities and Exchange Commission press release 2016-241, 17 November 2016, www.sec.gov/news/pressrelease/2016-241.html.

34 Jonathan Stempel, 'Credit Suisse pays U.S.\$77 million to settle Asia hiring corruption probes', Reuters, 5 July 2018, www.reuters.com/article/us-credit-suisse-settlements/credit-suisse-pays-77-million-to-settle-u-s-probes-into-china-hiring-idUSKBN1JV1XS.

35 Harry Cassin, 'Deutsche Bank pays SEC \$16 million to settle "referral hiring" FCPA violations', *The FCPA Blog*, 22 August 2019, www.fcpablog.com/blog/2019/8/22/deutsche-bank-pays-sec-16-million-to-settle-referral-hiring.html.

To mitigate such risks, referred candidates should go through the company's standard hiring process without any bias in selection and evaluation, and should be able to demonstrate that they have the requisite skills and experience to perform the job. Individuals with a prior personal, family or business relationship with the referred candidates must be removed from the hiring process to eliminate bias and the risk of a conflict of interest. These issues should be considered when performing due diligence both before and after a transaction closes.

Steps to mitigate the risk of doing business in China

Having taken a look at the various key risks of doing business in China, the following are some measures to consider in attempting to mitigate the risks associated with M&A in China.

Structure and strategy

Consider the structure of the entity that best suits the business strategy; for example, how much control over the operation the investor desires or requires. Do not underestimate the complexity of setting up an entity and unwinding structural inaccuracies.

Cash flows

Have a clear understanding of the restrictions for both the inflow and outflow of foreign monies.

Due diligence

Perform appropriate due diligence before and after the transaction. Where possible, perform transaction testing to assess the accuracy of the verbal representations provided by the target, and ensure a proper understanding of the target's go-to-market strategy and any third parties engaged.

Understand applicable laws and regulations

Do the homework necessary to identify and understand the various applicable rules and regulations, including pending regulations. In some cases, the entity in China may need to be compliant with two different sets of rules – one for China and one for the holding company's home country.

Utilise experienced advisers

When it comes to data protection regulation and state secret information, handle data and information with the utmost care. Where possible, process data and information in-country and do not remove it from China. Utilising advisers (eg, attorneys, accountants and data governance professionals) can support the appropriate handling of data and assist in avoiding violations.

Close monitoring

As corruption is endemic in China, operations in-country should be closely monitored with regular audits to identify potential breaches of laws and regulations and to create a culture of compliance.

Conclusion

Opportunities in China continue to appeal to foreign investors for a variety of reasons, despite the covid-19 pandemic, including advantages such as low-cost labour and materials as well as advancements in technology. With a population of approximately 1.4 billion based on United Nations data as at mid-2019, it is one of the most highly populated countries in the world.³⁶ Given these opportunities, the risks mentioned above are unlikely to discourage foreign investors who are keen to expand their business into China. Whether seeking availability of employees or resources or access to the consumer market, foreign companies stand to benefit significantly from investing in China, as long as the risk exposures are managed appropriately and mitigated where applicable and possible.

36 'Total Population by Country 2019', World Population Review, <http://worldpopulationreview.com/countries/>, accessed 26 September 2019.

Appendix 1

About the Authors

Jerry Hansen

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Jerry Hansen is a partner based in FRA's Dallas, Texas office. He has over 25 years of experience in accounting and forensic services including mergers and acquisition disputes, audit/accounting malpractice litigation, forensic due diligence, compliance monitorships and fraud investigations. Jerry's expertise includes serving as an expert or neutral arbitrator in resolving post-closing purchase price dispute arbitrations, providing expert and consulting services in audit and accounting malpractice matters involving the application of generally accepted accounting principles and generally accepted auditing standards, conducting all manner of forensic investigations, and providing forensic due diligence services relating to FCPA and UK Bribery Act risks. His experience covers a wide range of industries, including oil and gas, energy, real estate, technology, transportation, manufacturing, software, food services, publishing, automotive, healthcare, retail, staffing services, advertising, professional services and financial services. Jerry has previously served at a Big Four public accounting firm, a multinational consultancy and global corporations.

Jerry is a certified public accountant, licensed in Texas and California. He is the co-author of the book *M&A Disputes – A Professional Guide to Accounting Arbitrations* (Wiley 2017) and a contributing author to three additional books: *The Litigation Services Handbook*, *The Guide to Investigating Business Fraud* and *The Guide to M&A Arbitration*, as well as other articles and publications.

Weng Yee Ng

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Weng Yee Ng is a director in FRA's London office. She holds more than 16 years of experience in external and internal audit and forensic accounting. Her expertise includes compliance reviews, internal investigations, litigation support (both civil and criminal), risk assessments, evaluation of compliance programmes and FCPA monitorships for both the Department of Justice and the

Securities and Exchange Commission, disgorgement and penalty calculations, procurement fraud matters and third-party due diligence.

Weng Yee is currently working on a risk assessment and evaluation of compliance programme for an aviation company. She has recently completed compliance monitorships for a medical devices company and for a financial transaction systems manufacturer, both with global presence, a proactive anti-bribery and corruption review for an international bank, and several internal investigations into whistle-blower alerts for a CAC 40 automotive original equipment manufacturer. All of these have an Asian element, which involved in-country visits to China and other Asian countries.

Having spent over six years working in-country in Malaysia, Weng Yee possesses a first-hand understanding of the business nuances and financial and reporting practices encountered in Malaysia and in other South East Asian countries. She is multilingual in English, Malay, Cantonese and Mandarin, and is familiar with Bahasa Indonesia and Spanish.

Weng Yee is recognised in *Who's Who Legal: Investigations – Forensic Accountants* and as a Global Leader in *Who's Who Legal: Experts – Forensic Accountants*.

Michelle Zhao

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Michelle Zhao is a manager in FRA's New York office and specialises in forensic investigations and regulatory compliance matters in various industries and geographic locations. Michelle is experienced in foreign and domestic investigations relating to bribery and corruption, fraud, asset misappropriation, third-party compliance and employee misconduct. She has also assisted clients in proactively mitigating FCPA risk in their global subsidiaries and third parties through forensic due diligence, process assessment and risk remediation. Her industry exposure includes life sciences, healthcare, technology, financial services, manufacturing, consumer goods and state and local government.

Michelle is a native speaker of Mandarin Chinese and has spent extended time in China working with both global and local clients and their legal counsel on various types of forensic investigations, leading document review, email review, risk assessment, person of interest interview, and reporting findings and recommendations. Prior to joining FRA, Michelle worked for six years in the forensic investigations and regulatory compliance group at KPMG. She also completed a one-year global rotation in KPMG's Shanghai office.

Michelle is a certified public accountant, certified fraud examiner, certified internal auditor and project management professional.

Kezia Hardingham

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Kezia Hardingham is a manager in the forensic accounting team in FRA's London office. Kezia has worked on a wide range of engagements. Her expertise includes internal investigations, customer and third-party due diligence reviews, anti-money laundering compliance reviews and fraud and corruption investigations.

Prior to joining FRA in 2018, Kezia worked in the forensic team of KPMG in London. Since joining FRA, Kezia has investigated allegations of bribery and corruption, accounting

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misstatements, channel stuffing and other types of misconduct across a variety of jurisdictions. She has also worked on anti-money laundering and terrorist financing reviews for European financial institutions. Kezia has previous experience of writing source of wealth and bespoke corporate intelligence reports. She has provided forensic accounting support on a large cross-border bribery and corruption review of a company under investigation by the UK's Serious Fraud Office and France's Parquet National Financier. She has also recently worked on an investigative anti-money laundering review for a European bank.

Kezia's previous project experience includes conducting e-review and providing forensic accounting support for a large accounting fraud investigation.

Kezia is a chartered accountant (ICAEW) and an accredited counter-fraud specialist. She has a bachelor's degree in Chinese and Asia-Pacific studies from the University of Leeds. Kezia has spent extended time in China. She has also worked on China-related matters from the UK, including performing enhanced due diligence on a global company's third-party relationships in China, Hong Kong and Taiwan as part of a large anti-bribery and corruption review. She has written several articles on regulatory, economic and political issues across China, India and South East Asia.

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