Financial News

Law.com

The China Syndrome

Thursday May 26, 3:01 am ET

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The takeover of China's Harbin Brewery Group last summer was filled with nail-biting excitement worthy of any M&A deal on Wall Street. In May 2004 Anheuser-Busch Companies Inc., acquired 29 percent of the Hong Kong-listed company's shares. In turn, London-based SABMiller, which already owned over 29 percent of Harbin, launched a hostile takeover of the Chinese company three days later. But Harbin's management sided with Anheuser-Busch, and SABMiller withdrew its bid. In July 2004 St. Louis-based Anheuser-Busch bought the brewery for a cool $739 million.

That battle was more than just high drama. In many ways, it signaled the future of Chinese business. Not only did it rank as the first-ever contested takeover of a public Chinese corporation, but also the deal would never have happened just a few years ago because very few Chinese companies listed shares abroad, says Michael Moser, whose law firm, Freshfields Bruckhaus Deringer, represented Anheuser-Busch. He says that the transaction also looked much like any U.S. deal. The lawyers dealt with many of the same issues: due diligence, documentation, representations and warranties. Chinese businesses are famous for their creative accounting, but like those of any corporation that borrows from an international bank, Harbin's books resembled a U.S. company's. "China is becoming much more sophisticated and international," says Moser, who is Freshfields's China managing partner and heads the firm's China Business Group.

In the three-and-a-half years since China joined the World Trade Organization, it has leapfrogged into modern-day capitalism. The country attracted a record $60.6 billion in foreign investment in 2004, while GDP surged 9.5 percent, with only a slight dip predicted for this year. But while China offers enormous potential for foreign companies, the familiar pitfalls -- piracy and counterfeiting, bewildering cultural differences, mind-boggling bureaucracy, local protectionism, and vestiges of the old state-run system -- remain. In many respects, China is like a modern-day gold rush. "The economic opportunity is massive, but not everyone is going to make it," says Eric Newman, general counsel of the Charlotte, N.C.-based Bojangles' Restaurants Inc. The fast-food chain opened its first Chinese franchise in January.

Corporate Counsel asked in-house counsel, outside lawyers and other experts on China for ten tips on how to better the odds for success.

PAIR UP, BUT WITH A GRAIN OF MSG

In the last two years, it seems as though 1,000 M&A deals have bloomed in China. "The range and variety of transactions is something we've never seen before," says Douglas Markel, a colleague of Moser's at Freshfields. Contributing to the merger mania: a new regulatory framework, an expanded range of industry and investment options, and a newly streamlined government approval process. As a result, the traditional joint venture of the past has ceded to a Pan Asian menu of investment opportunities, Markel says. For instance, foreign companies can now buy equity in or assets from a Chinese company (without a local partner), or, for the truly intrepid, invest in China's volatile stock market.

Unsurprisingly, a lot of transactions fall through at great financial cost to the outside investor. When the ailing British car company MG Rover Group Limited sought to partner with the Shanghai Automotive Industry Corporation last year, SAIC agreed, then pulled out at the eleventh hour, according to press reports. Without SAIC's backing, MG Rover ran out of money and went into receivership in April. (The companies declined to comment on their transaction.)

In general, experts say, Chinese inexperience in M&A, language barriers, unorthodox accounting (many Chinese companies have two sets of books -- one for the company and one for tax purposes), and government involvement are just a few of the issues that can sour an acquisition. Chinese deals also typically cost more than their U.S. counterparts: "Take a look at the size and complexity of the transaction, estimate what it would cost in the United States, and double or triple that," Markel says.

BEWARE THE BALD EAGLE DIVE-BOMBING YOUR DEAL

M&A is no longer a one-way street. In March, IBM Corp. got U.S. approval to sell its personal computer business to China's Lenovo Group Limited for $1.75 billion. The deal could signal the start of a shopping spree by Chinese companies, which is good news for multinationals seeking foreign investors. But U.S. companies need to tread carefully.

The Committee on Foreign Investments in the United States, or CFIUS, a federal multiagency group, can kill any foreign investment here for national security reasons, and it gave the IBM/ Lenovo transaction an unusually close look. "Chinese deals in particular are going to be closely scrutinized," says William Reinsch, president of the National Foreign Trade Council, a Washington, D.C., industry group promoting trade. "There's a good bit of paranoia about China and its intentions."

CFIUS has vetoed deals with China before. In 2003 a negative CFIUS review forced Hong Kong-based Hutchison Whampoa Limited to retract its bid for Global Crossing Limited, the Florham Park, N.J.-based telecommunications carrier.

Exon-Florio, the 1988 law that gives CFIUS its review power, also authorizes the president to unwind a done deal. The only instance that a president has taken such a drastic step involved a Chinese company. In 1990 President George Bush ordered the government-owned China National Aero Technology Import and Export Corp. to divest its interest in Mamco Manufacturing Inc., a Seattle aircraft component maker.

IBM/Lenovo and Global Crossing/Hutchison Whampoa suggest that CFIUS's focus is shifting from traditional defense contractors to a broader range of industries, says Ronald Lee, a partner at Arnold & Porter in Washington, D.C. Export controls, government contract issues, and Sarbanes-Oxley must be factored in too when U.S. corporations are weighing Chinese deals. "Companies need to map out the possible security concerns at the start of the planning process, decide what deal structure and timing makes sense, then overlay that with the other regulatory agencies involved," Lee says.

RED CHINA, REDDER TAPE

In December another door to the East swung open with the enactment of a new Chinese law permitting foreign businesses to import and distribute their products in the country without local partners or through middlemen in Hong Kong or Singapore. To open a mainland trading outpost, businesses need to invest as little as 300,000 yuan ($36,000) in the office, "possess a sound reputation, and comply with Chinese law." An earlier law that took effect last July allows foreign firms to set up majority-owned trading joint ventures with Chinese companies; previously, foreigners could trade only as minority owners.

Unfortunately, "not a whole lot has happened" since either law kicked into effect, says Peter Neumann, a partner at Faegre and Benson in Shanghai. "There's a huge bureaucratic bottleneck in Beijing -- they don't have the manpower to handle the backlog of applications," he says. "There's a concern that China is not following through on its promises." Although several companies, including the Wayzata, Minn.-based agricultural giant Cargill, Inc., and Tokyo-based Sojitz Holdings Corp., have publicly said they've applied for the right to set up a wholly-owned trading company, and lawyers say that scores of others have applied, China's Ministry of Commerce has yet to announce approval of a single application.

Being able to sell directly to Chinese consumers is "the single biggest issue among multinationals in China," Neumann says. He explains that having their own distribution channels will allow companies to sidestep the corruption and inefficiencies of some Chinese channels.

FOLLOW THE USUAL RULES OF BUSINESS

With such a booming economy, it's tempting to get caught up in the hype and pay less attention to the normal rules of business. Big mistake, says Bojangles' GC Newman, who spearheaded the fast-food chain's franchise agreement to build ten restaurants in China. (The first location opened in China's third-largest city, Tianjin.) On top of typical government and real estate issues, Newman had to find suppliers for 190 components, from Cajun-style spices to equipment for the mini-basketball court featured in the Tianjin restaurant. He says due diligence with local suppliers was key, because "people are very quick to say that they have the ability to do something by a certain date, and you only find out very, very late that they don't." Newman hired local attorneys and consultants to find suppliers with good reputations and track records -- "you find out who is servicing your competitors," he says. "You always have to be careful who you're dealing with. [But] in China you! have to be three times as careful."

FOR IP, IT'S STILL THE WILD, WILD EAST

Intellectual property has been a huge sticking point for foreign businesses in a country famous for its brazen piracy. It still is: In a February speech, deputy assistant U.S. secretary of State Shaun Donnelly said China's inadequate protection of IP rights "remains [the United States's] most serious concern" about trade with China. The International Intellectual Property Alliance, a Washington, D.C., trade group, estimates piracy in China cost U.S. businesses $2.5 billion in 2004.

But Cherry Fan, a Shanghai-headquartered lawyer at the Philadelphia-based chemical producer Rohm and Haas Company, says things are getting marginally better. In December, China lowered the monetary thresholds that trigger criminal treatment of trademark and copyright infringements, although it left the thresholds for patent and trade secret infringement alone. Though high, the existing thresholds are not insurmountable: A former Rohm and Haas technical manager was recently sentenced to a year in prison for theft of trade secrets, Fan says.

China's crackdown on IP infringers can cut both ways. Nike Inc., discovered this in December, when a Beijing court ordered the Beaverton, Ore.-based sportswear giant to pay $36,000 to a Chinese cartoonist. Nike used his "Little Match Man" without proper copyright authorization in an advertising campaign featuring athletes playing against a cartoon stickman. The company, which has appealed, did not return calls for comment.

Dawn Haghighi, in-house counsel at Charter One Bank in Chicago and a past president of the Hong Kong Business Association of the Midwest, says the Nike decision shows that China is starting to pay attention to IP: "As we see more Chinese-made brands, we'll also see more interest within the country in protecting IP rights."

A WORKERS' PARADISE -- EXCEPT WHEN IT ISN'T

Like intellectual property, labor rights are a work in progress in the People's Republic. In 2003 the number of cases involving labor disputes reached 300,000, according to China Labor Bulletin, a Hong Kong labor rights group. And exploding production has created even greater pressure on the workforce. Yet multinationals, prodded by American consumers and shareholders to uphold acceptable health and safety standards at their Chinese subcontractors, face major hurdles in these areas. "China has a fairly good set of [occupational health and safety] laws, but at every stage of government, there is room for exclusions or exceptions," says Gregg Nebel, regional head of social and environmental affairs for Adidas-Salomon AG, the German sportswear company. "We'll go to a factory, and the management will pull out a piece of paper that shows they got an exception." Nebel says that outside suppliers' compliance with Adidas's standards for wages and benefits, as well as the com! pany's rigorous health, safety, and environmental benchmarks, is "probably our most pressing issue."

To make matters more complicated, multinationals must also contend with the All China Federation of Trade Unions (ACFTU), the country's only legal union body. In September, Wal-Mart Stores Inc., made the kind of headlines that companies would rather avoid when it was named by the ACFTU as one of several overseas companies allegedly refusing to comply with Chinese laws obliging them to establish unions. Wal-Mart isn't talking, except to state publicly that should its workers "request the formation of a union, Wal-Mart China would respect their wishes and honor its obligation under China's trade union law."

THE GOVERNMENT STILL MATTERS

The Chinese government casts more than just a watchful eye over business transactions -- it plays multiple roles in them, including that of policeman. Case in point: David Ji, chairman of Apex Digital Inc., a DVD manufacturer in Ontario, Calif. In October, Ji was arrested in China on charges that his company reneged on nearly $500 million it owed to a Chinese supplier, Sichuan Changhong. According to court documents filed in California state court, Sichuan accused Ji of fraud, had him imprisoned, and tried to take over his company's U.S. assets. (Apex did not return a call for comments, and Ji's lawyers at O'Melveny & Myers declined to comment. Ji apparently remains under house arrest in China.)

Usha Haley, professor of management and international business at the University of New Haven, who studied Apex for a book on China, says that Sichuan, as one of China's largest exporters, is a favorite of the Chinese government. (According to court documents, it is also majority-owned by government officials.) When Sichuan's business took a downturn, Apex "served as a convenient scapegoat to pacify various stakeholders in China," she says.

"To do business in China, one has to navigate business, government and clan networks simultaneously," Haley says. "When things turn sour, as they often do in China's volatile business environment, the foreign partners provide the easiest links to break."

STEER CLEAR OF GUANXI PEDDLERS

Doing business in China is not all about making and keeping connections. "One of the most tiresome observations from the 'instant expert' on China is that relationships (or guanxi) play a very important role in doing business in China," says Walker Wallace, a partner at O'Melveny's Shanghai office. Wallace says that when China first opened up to foreign investments, connections were key. Personal relationships still play a larger role in business than in the United States, but as China has become more sophisticated, guanxi has become less important, he says. Foreign companies that are new to the mainland, however, can get taken in by influence peddlers who tell them, "It's all about guanxi," Wallace says. "They sell you a bill of goods, claiming they know this guy and that guy, then take your money and run."

KEEP IT CLEAN

Overreliance on guanxi can cause trouble back home, too, as Lucent Technologies Inc. recently learned. According to regulatory filings, Lucent is being investigated for violating the Foreign Corrupt Practices Act, which prohibits bribing foreign officials. In April 2004 Murray Hill, N.J.-based Lucent fired four senior executives at its China subsidiary, reportedly for awarding kickbacks and other perks to secure contracts. (Lucent declined to comment.)

Lucent is the most high-profile, recent example of U.S. executives in China who allegedly lost sight of U.S. laws while working in a foreign culture in which greasing government palms is a time-honored practice. Invision Technologies, a Newark, Calif., maker of security scanners, paid $1.9 million in February to settle a federal probe of alleged bribes to officials in China, the Philippines, and Thailand to help sell the company's bomb-sniffing machines. Invision did not return calls for comment.

China also has antibribery laws of its own. Fidelity Information Services Inc., recently found this out the hard way. The Jacksonville, Fla.-based financial software firm is under investigation in China for allegedly giving $1 million to former China Construction Bank chairman Zhang Enzhao. The bribe was allegedly part of a scheme to deprive a consulting firm of $59 million in commissions for putting a deal together. The consultant, Grace & Digital Information Technology in Beijing, claims that FIS and Zhang conspired to rewrite contracts for a new $176 million computer system for the bank that illegally cut Grace out of the deal. (FIS declined to comment.)

WHEN DISASTER COMES A-COURTING, DON'T GO TO COURT

In such a tricky business environment, it can be hard to avoid disputes. Should a disagreement with a Chinese partner arise, avoid Chinese courts, says Denis Brock, a Clifford Chance partner in Hong Kong. "It's a very dangerous place to be," he says, "because you're going to lose." Instead, make sure every contract includes an arbitration clause, preferably offshore, in a country whose arbitral bodies are better known and have more familiar procedures than their Chinese counterparts, he says. If stuck with mainland arbitration, use the China International Economic and Trade Arbitration Commission, or CIETAC, Brock advises.

But nothing is easy or simple in China, even if a company wins in arbitration. In 2001 Toronto-based TriNorth Capital Inc. won a $4.2 million arbitration award against Guilin South Rubber (Group) Corporation. When TriNorth asked the local court to enforce the award, it refused to issue a decision. The local judges were appointed by the municipality, which also happened to own Guilin. TriNorth appealed to the People's Supreme Court of China in Beijing, and finally, just last year, TriNorth got its order of enforcement -- and payment from Guilin.

Brock says that unenforceable arbitration awards do have their uses -- as a bargaining tool. Many companies arbitrate simply so they can use the award as leverage in negotiating future deals, Brock says. But that's not in the cards for TriNorth, says president and CEO John Pennal: "Once bitten, twice shy."