Due Diligence in Merger and Acquisition--With China Practice View

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Abstract

The due diligence in merger and acquisition, which has been normal in the United Kingdom and the United States for decades, is now spreading to the globe. Due diligence is becoming a widely accepted practice in merger and acquisition deals in China. Before indulging into this flaming market, due diligence is requisite to foreign investors, concerning the special social and economical situation.

Key words: due diligence ; merger and acquisition; foreign investment

Introduction

Throughout the world, business is being challenged to create shareholder value. Mergers and acquisitions have become a core part of playing this role. In the half of 1999, reports Securities Data Publishing of Newark, New Jersey, the total value of all M&A transactions exceeded $891 billion in the U.S. and more than $1.5 trillion worldwide. In the first four month of 2000 alone, more than 11,653 companies worldwide announced M&A deals worth over $1.32 trillion. [1]And the level of mergers and acquisition activity has remained remarkably persistent until today.

Despite the considerable interest and experience in M&A worldwide, many acquisitions fail to create value—and some actually diminish it. In a recent survey, up to 80 percent of M&A transactions destroyed or failed to create value. [2]Why such shortfall? While there is no single reason for the high failure rate, many transaction are unsuccessful because the acquirer cut corners on due diligence—downsizing or delegating important due diligence work. Mistakenly believing that they can gain time, save money, or spare feelings by shortening this deal phase, acquirers miss out on this valuable one—time chance to explore the risks inherent in buying another company before signing on the dotted line. Other contributing causes include lack of strategic clarity and failure to execute in line with the corporate strategic plan.

The due diligence phase of any acquisition can make the difference between success and failure. Good due diligence begins even before an acquisition prospect is identified. The objective of due diligence is straightforward and simple. The acquirer is interested in minimizing its exposure to the many problems and pitfalls that can arise when making an acquisition. The process itself is decidedly less simple. The acquirer must begin with clear and explicit expectations of the benefits it hopes to gain by making the acquisition. Only by clearly understanding these expected benefits at the outset can the appropriate due diligence procedures be identified and efficiently carried out. It is critical to understand that due diligence is an essential part of any well-executed acquisition process.

Due diligence is a structured, systematic research effort used to accumulate the facts necessary to make an informed decision regarding an acquisition candidate, thereby increasing the chances of the acquisition's success.

To put due diligence in its proper perspective, this article begins with the legal foundations of due diligence, then, I discuss the "what, when and who" of due diligence—that is the *scope*, *time* and *key participants*, followed by the legal compliance review. At the final stage, I

1. The Legal Origin of Due Diligence

The term "due diligence" is neither statutorily defined nor referred to as setting a standard for the breadth or depth of a professional's review in the context of a corporate acquisition or a public securities offering. Nevertheless it has come to have significant meaning in both contexts, at the transaction stage and, potentially, at least, at litigation stages. [3]

Neither of the two most significant statutes—the Securities Act of 1933 and the Securities Exchange Act of 1934—employ the term due diligence. But although the term does not appear in federal securities laws, securities lawyers do use a "due diligence defense" to protect their clients from lawsuits alleging violation of securities laws.

In the context of a securities offering it generally refers to a defense to a variety of administrative and private actions available under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"). When a corporate acquisition is involved, the 1934 Act's disclosure and tender offer rules often provide bases for suits against a variety of the parties involved. In either context, however, the term due diligence refers to an affirmative duty to ensure compliance with disclosure obligations and the investigation that is part of nearly every issuance of securities and corporate acquisition, whether out of an affirmative duty or a thought to a future defense.[4]

The most commonly cited due diligence case is Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). When BarChris Construction, a bowling alley builder, went bankrupt, bondholders accused its directors and officers of violation Section 11 of the Securities Act of 1933 by making material misstatement and omissions in their registration statement.

Citing the Section 11, the court found there were misstatements and omission in both the expert and non-expert portions of the registration statement. It held that the inside directors of a corporation, that is, those directors who were also officers of the corporation, had not proved their due diligence defenses to a claim of liability for violation of Section 11, because they had been closely involved with the affairs of the corporation, including the offering of debentures pursuant to a registration statement and prospectus that were found to contain material misstatements and omissions, and there is nothing to show that they made any investigation of anything which they may not have known about or understood. With respect to the corporation's house counsel, who had become an assistant secretary and a director when amendments to the registration statement were filed, the court found that although he had not participated in the management of the corporation, he had performed routine legal work for it, incorporated several subsidiaries, examined the corporation's contracts, and, more important, kept the corporate minutes and the minutes of the subsidiaries, which had kept him informed of the corporation's affairs. The court found that he had made no investigation and had relied on the other officers and directors to get the correct information about the company.[5]

Furthermore, the court held the outside directors liable for the non-expert portions. It was the responsibility of two outside directors of a corporation, that is, directors who were not also officers in that corporation, to make a reasonable investigation of those portions of a registration statement not prepared by auditors and not to rely, as they had, on officers and other directors of the corporation. Although one outside directors had been elected to the board at about the time that the registration statement had been almost ready for filing, the court noted that Section 11 imposes liability in the first instance upon a director, no matter how new he is. Another outside director, who was a partner in a law firm representing the corporation in matters pertaining to the registration of securities, was found not to have made any reasonable investigation of the part of the statement not certified by any expert. The court found that he was most directly concerned with writing the registration statement and assuring its accuracy, and held that because of this, more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work.

While he was not expected to make an independent audit of the figures supplied to him by the corporation, the court held that there were errors and omissions which he could have detected without such audit, and as to which he had been content to rely on the word of his clients.[6]

Although the "due diligence defense" emerged from the litigation context, it is typically viewed as providing a guide for attorneys charged with the responsibility of reviewing a company's disclosure obligations, assessing the legal risk associated with particular aspects of the company's business and evaluating the viability of a proposed offering or acquisition. This article is designed to provide a practical overview of the nature of due diligence, against the backdrop of its intended purposes of shielding parties from liability and ensuring the efficacy of a proposed transaction. Since other materials will deal with due diligence in the context of a public offering, this article will focus on due diligence in the context of an acquisition transaction.

2. The Due Diligence in M&A

In M&A, due diligence refers primarily to an acquirer's review of an acquisition candidate to make sure that its purchase would pose no unnecessary risks to the acquirer's shareholders. The term also refers to the mutual review undertaken by the two parties to a merger. Finally, the phrase can apply to a candidate company's review of the acquirer to ensure that relinquishing control will not bring unreasonable risks to the company's owners or employees. [7] The purpose of due diligence in the context of a proposed acquisition transaction is to provide the potential acquirer with sufficient information regarding the target company so that the acquirer may make a reasoned decision as to whether or not to pursue such a transaction and, if the decision is made to pursue such a transaction, what the appropriate terms and price might be. The decision made with respect to price must also consider potential liabilities, including any post-transaction indemnification obligations.[8]

1) The scope of due diligence in the M&A

At a minimum, the due diligence effort should be viewed in such areas:

- In the *financial area*, due diligence must not only evaluate past operating results, but also incorporate those results into the acquisition business case, taking competitive threat into account. This applies whether the focus is on revenues, operating margins, cash flow, or any other financial category.
- In the *operational area*, due diligence requires a multitude of issues to consider. These include not only the quality of management system they have put in place, but also the quality of the people running those systems. Sellers and buyers alike can benefit from discreet background checks on the new partners. More generally, there is the issue of post-acquisition culture and merger integration.
- In the *legal arena*, due diligence requires to check for potential future legal problem stemming from the candidate company's past. It is imperative to take into account intellectual property law, tax law, antitrust law, consumer protection law, environmental law, and employment law, ect.. [9]

2) How deep should due diligence be?

How far a buyer whishes to go in the due diligence process depends in part on how much time the buyer has and w much money it has to investigate the company it wishes to buy. This will depend to some extent on the status of the company in the community, the year it has been in business, whether it has been audited by a major firm for some years, whether executive turnover is low, and any other factor that helps establish the basic stability of the firm, such as long-term customer retention. If a broker is involved in the transaction, the broker may wish to require some basic level of acquirer due diligence. In fact, it is not unusual for brokers to include a contractual requirement that the buyer undertake due diligence. [10]

Furthermore, the due diligence can vary by type of companies. The due diligence work in the acquisition of a large, diversified, global manufacturer listed on several stock exchanges is obviously far more extensive that the work involved for a small, single-product, domestic service firm that is privately owned. Due diligence in public companies can be more complex than due diligence in private companies.

- As to *public company*, which has issued securities has already been the subject of a due diligence study by underwrites and their counsel in preparing the company's original prospectus. Acquirers, then, can use the company's prospectus as a guide, and can rely to some extent on the due diligence that the prospectus required.
- As to *private company*, due diligence becomes a much more intensive process. The acquirer will have to do more investigation of the seller, and will ask the seller to provide assurances via representations and warranties in the acquisition agreement. Thus, the scope of a private company investigation depends in part on what information the seller is willing to give in the form of the representations and warranties to be included in the purchase agreement. [11]

Finally, transaction type can limit the due diligence effort:

- In the context of *stock sale*, no matter how accounted for, the resulting entity will bear all the liabilities of both parities to the transactions, so the level of due diligence obviously has to be as extensive as possible
- In the context of *assets sale*, generally, the successor is not liable for the debts and legal liabilities of the predecessor unless it expressly assumes them, therefore due diligence need not include a study of debts and legal liability exposure. On the other hand, acquires that are used to the protections of securities laws should realize that these laws do not apply to any transaction structured as an asset sale. [12]
- In the context of *an unsolicited transaction*, the potential acquirer must be prepared to act on the basis of available public information. Since the transaction is unsolicited, the acquirer will not have had access to the target company's confidential information, so all decisions must be made on the basis of information available in the public domain and, if available, sources that are not bound by confidentiality agreements.
- In the context of *a negotiated acquisition transaction*, the potential acquirer will have signed some form of confidentiality agreement in exchange for confidential information regarding the target company. In the course of such review, potential acquirers will be able to perform their due diligence investigation.
- If the potential acquirer is *a competitor* of the target company, antitrust implications must be taken into account in the due diligence process. To some extent, this will limit the effectiveness of the due diligence investigation, but, at the same time, it protects the target company, by not disclosing sensitive information to a competitor. Antitrust counsel should be consulted. [13]

When the acquisition agreement is drafted, due diligence should continue as issues arise in the preparation of schedules and the appropriate scope of the target company's representations and warranties. In this regard, exceptions to representations and warranties will be made on the basis of whether or not the exception is “material” or will have a “material adverse effect.” Therefore, it is important for acquirer's counsel to carefully draft the definitions of such terms in the acquisition agreement, so that as much as possible will be disclosed on the schedules to the acquisition agreement.[14]

3) The time of due diligence

The initial stag of due diligence takes place before the acquirer agrees to proceed with the acquisition. It unfolds during the search and screen, valuation, and financing process. Throughout the acquisition process, due diligence may last from a few weeks to a year or more. This is a very expensive process for the acquirer if it chooses to terminate the process or to bear extra costs if items which should have been taken into account during the due diligence investigation arise later in the process.[15]

When buyers do initiate a formal, organized due diligence investigation, they should put it on a fast track. Speedy due diligence ensures minimal disruption to ongoing business activities and lower out-of-pocket costs to both parties. Another benefit can be smoother relations between the parties. The most valuable result of fast-track due diligence is timely information so the buyer can quickly determine whether the acquisition is of interest, and if so, on what terms ad conditions. The buyer can then focus attention on determining the appropriate structure for the transaction; the basis for calculation of the purchase price; what representation warranties, and covenants should be negotiated into the final acquisition agreement; and what conditions to closing need to be imposed. [16]

As important as it is for due diligence to be completed rapidly, the due diligence effort really should extend beyond closing. The discipline imposed by the process—dealing with the realities of the complications of business—should never be abandoned, and it is a rare deal that does not have, on closing day, a revision to the acquisition agreement covering unfinished items of due diligence inquiry. [17]

4) The key participants in due diligence

To conduct due diligence, the acquirer typically draws from in-house sources of expertise and from retained consultants and advisers.

At a minimum, the due diligence team will include accounting personnel for the financial statement review and legal personnel for the liability exposure review. The two have separate and distinct responsibilities, although they may communicate with each other. The acquirer may also bring in economic consultants, engineers, environmental experts, and a host of other professional talent.

Typically, the outside counsel to the acquirer directs the review, with the help from a variety of other agents of the acquirer. These agents might include senior management, internal legal and accounting staff, external accountants, and investment bankers. The party directing the review should be clear from any conflict of interest. [18]

In the Unites States, the buyer's lawyer typically assumes a major role in the organization and management of the due diligence process. This responsibility includes identifying the legal matters to be investigated, and the means to be employed for this purpose, but the lawyer must also participate in decisions as to other areas of investigation in order to minimize the risk that certain areas may be overlooked because of differences of view as to whether the dividing line between legal and business issues is to be drawn. Of course, the lawyer's role is not limited to discovery of facts and circumstances. The implication of the facts and circumstances must also be understood and communicated to the client in a manner that permits the lawyer and his client to react in a reasoned manner. Often this entails a search for ways in which identified risk can be limited and quantified. [19]

3. Due Diligence Practice in China

The above discussed due diligence, which has been normal in the United Kingdom and the United States for decades, is now spreading to the globe. There persist an ever-growing tendency, not only in Common Law countries, but also in jurisdiction with a Civil Law system, towards increasingly complex disclosure procedures and more and more voluminous agreements in the practice of corporate acquisition.

However, in an international context, this situation is even more difficult. It is clear that each country has different legal principles. For this reason a literal translation of a legal term often does not have the same meaning in another country. It has also become clear that each country has different typical dangerous aspects for buyers of enterprises, which must be investigated. [20]

According to the United Nations 2006 World Investment Report, China received $72 billion in 2005 and $61 billion from foreign direct investment, following the United Kingdom and the United States, ranked the third recipient in the world. However, before indulging into the flaming market, due diligence is requisite to foreign investors, concerning the special social and economical situation.

1）Customary practice

Due diligence is becoming a widely accepted practice in merger and acquisition deals in China. The extent of due diligence both, in terms of what is required by Buyer and what is permitted, in terms of available information and time given by Seller, depends on various factors:

a. Whether it is an acquisition of shares, business, or assets;
b. Whether the deal involves a State-owned, collectively owned, public, or private company;
c. Whether the deal involves foreign investments;
d. The industry of the Target and relevant industry regulations;
e. Buyer's familiarity with the Target;
f. The nature and commercial objective of the transaction;
g. The time and cost of conducting the due diligence investigation;
h. The extent of, and limitations on liability for, contractual warranties;
i. The reputation and financial standing of Seller;
j. The relative bargaining strengths of the parties;
k. The nature and amount of the consideration.

Due diligence is therefore intended, among other things, to assist a purchase in developing an understanding of the Target's business and organizational history; verifying assumptions made by Buyer in respect of the Target and its business; facilitating its evaluation of the assets of the Targets; conducting its assessment of exposure and commitment of the Target.

All of which could eventually affect the pricing of the deal, the extent of the contractual protection in the definitive agreement, and even whether a deal is to be concluded or not. Legal due diligence in China usually focuses in the following principal areas:

a. Target corporate structure;
b. Government approvals in relation to the establishment of the Target;

c. Permits, licenses, and government approvals in relation to Target's operation;
d. Target's formation documents
e. Foreign investment involved
f. Titles to property(real estate, tangible, and intangible assets);
g. Material agreements;
h. Financial information(liability and contingent liabilities);
i. Labor law compliance;
j. Employment contracts, welfare and social insurance;
k. Tax information including the tax preference documents;
l. Insurance;
m. Environmental violations and compliances;
n. State or local subsidies;
o. Contentious matters such as litigation and arbitration, potential dispute, and compliance with laws and regulations, ect.;

While performing the due diligence in China, special attention shall be paid to the following documentations:

a. Governmental approvals (in terms of establishment, operation and ect.);
b. registration with Central and local administration of Industry and Commerce;
c. registered capital/ total investment, actual capital contributions verifying by CAP, and the yearly examination certificates;
d. foreign exchange registration if foreign investment involved;
e. examination and approval documents issued by the competent environmental protection administrations;
f. property title documents;
g. land use rights certificates;
h. bank loans and outstanding debts, contingent liabilities;
i. encumbrances;
j. compliance with governmental regulations in specific industries;
k. unpaid taxes and custom duties;
l. employment contracts and standard welfare compliance;
m. unrevealed transactions that are not concluded on arm's length-basis

2）Timing

The stage at which due diligence commences is usually determined by commercial decisions of the parties involved—the need of the Buyer to be comfortable with respect to the affairs of the Target before entering into any contract to acquire it and the willingness of the Seller to allow an extensive due diligence to be conducted before the parties have contractually committed to the transaction.

It is customary for Seller in China permitting Buyers to commence due diligence prior to execution of a definitive agreement, which is often in the form of a memorandum of understanding or a letter of intent. In case of due diligence prior to conclusion of definite agreement, a confidentiality undertaking is expected before due diligence exercise is permitted.

There are typically two ways in which due diligence is conducted in China-Normally a data room is set up either at Seller's premises or at the offices of its attorneys or financial advisors. The relevant documents are kept in the data room, and due diligence is performed on-site by Buyer (together with its attorneys). The advantage of such an approach is that Seller retains physical control of its documents. But sometimes, copies are not allowed to made and taken out from premises. The other approach is where copies of the due diligence documents are delivered to Buyer by Seller.

In both cases, Seller will usually provide documents pursuant to a comprehensive request furnished by Buyer. The content of this list covers various factors and generally the additional information or document will be required by Buyer based on the result of initial due diligence, Buyer's attorney will prepare a formal due diligence report.

There is no fixed timing for due diligence exercises in China. The schedule depends on (i) the size of the transaction; (ii) the amount of documents to be reviewed, and (iii) the schedule of negotiation. The timing is sometimes also affected by the other deadlines in the transaction, such as the projected and completion dates.

3）Duties to disclose/ investigate

There is no other statutory compulsory provision specifying the duty to disclose by Seller in PRC law generally, except as discussed below. The PRC Contract Law provides that the parties shall exercise their rights and perform their obligations in good faith. In the Contract Law, there are no specific provisions relating to the constructive knowledge of the Seller. If during the course of concluding a contract, a party deliberately conceals any important fact relating to the conclusion of the contract or provides false information; such party shall be liable for damages the other party suffered. There was such a lawsuit filed against the liable party. However, since the liable party could not be located, the injured party was not able to recover damages.

The PRC Securities Law provides that, if a major event occurs (such as a merger) that may have a relatively serious impact on the price of a listed company's shares, and it is not known by the investors, the listed company shall immediately report to the China Securities Regulatory Commission (CSRC) and the Stock Exchange where it is listed, and make an announcement to the public. This obligation to report and make a public announcement begins when a Letter of Intent, a merger agreement, or a Share Escrow Agreement is executed by the parties. When a rumor occurs that might affect the market, the Exchanges or the CSRC may ask the listed company to make a public announcement as well, even if the event has not occurred.

As a supplementary alternative, the Buyer usually requests the Seller to make representations or warranties that up to a certain critical date, all the information the Seller has provided is true and correct and not misleading in all respects, and Seller is responsible for the representations or warranties made. Under the PRC laws, there is no compulsory obligation for Buyer to investigate into seller's assets and equity interest.

4）Legal Restriction

China has numerous regulations, circulars and rules concerning the administration of State-owned assets. Such information may be searched online, though most of it is written in Chinese. In the case of any transfer of State-owned assets, an evaluation will be conducted and the result will either be filed or approved by appropriate State-owned assets administration authority. In recent years, foreign investors have engaged in transactions that involve acquiring and merging companies that possess State-owned assets. For such transaction, due diligence about the nature of the Target is more important because an evaluation of the assets of the Target must be done even if the Target is not a State-owned company, but a vehicle for State ownership. There are certain "investment trust companies" in China that for some transactions, act as vehicles add hold the State-owned equity on behalf of State-owned companies. Under such circumstances, specific inquiry must be made into the assets they hold in trust to avoid violating the law or invalidating the transaction.

Subject to the final government approval, an evaluation result is still negotiable between the parties with no binding effect.

According to PRC Securities Law, a person is prohibited from dealing in certain securities if he is in possession of "insider information" or acquires the "insider information" illegally. That information (i) concerns the company's business or finances; or (ii) may affect the market price of the company's securities; and (iii) is not available to the public. Therefore in conducting due diligence on a listed company, special care should be taken if the information provided by the Target is inside information. Buyers should forbid its employees or representatives who obtain this information during the negotiation process and not engage in any securities transaction of the listed Target company.

Additionally, with on definition and pre-clearance procedures exiting, no information is allowed to be disclosed if the Target's disclosure triggers "national security" issues. The Seller should address a specific representations and warranties provision in the transactional agreement that no national securities issues are involved.

Any foreign investment in China is directed by Foreign Investment Industries Guidance Catalogue, which divides foreign investment into four categories: (i) encouraged, (ii) permitted, (iii) restricted, and (iv) prohibited.

In the event that a foreign Buyer institutes a merger or acquisition of a Chinese company, specific attention shall be paid when the Target's industries fall into theses restricted or prohibited categories. A new regulation, "Regulation on Foreign Investment of Merger & Acquisition" was implemented on September 8, 2006. According to Article 12 of this new regulation, when foreign Buyer obtain an actual controlling equity interest through merger with or acquisition of a domestic enterprise which involves a key industry, involves factors which may impact or actually impact State economic security or results in the possession of a well-known trademark or old Chinese brand of the domestic enterprise for which actual controlling rights are transferred, then the parties shall report this to Ministry of Commerce. In addition, during the examination and authorization of the merger and acquisition of a foreign investment, anti-monopoly examination is included, which reflects Chinese government's intention on the protection of domestic markets. [21]

References

[1] See Phillp, J, Clements, "*Due Diligence: A Safety Net for Shareholder Value*", PricewaterhouseCoopers LLP, New York, New York.

[2] Id.

[3] David A. Katz &Wachtell, Lipton, Rosen & Katz, "*Due Diligence in Acquisition Transaction*" , Practicing Law Institute, Corporate Law and Practice Course Handbook Series, June, 2007

[4] Id.

[5] See Escott v Barchris Constr. Corp. (1968, SD NY) 283 F Supp 643

[6] Id.

[7] Alexandra Reed Lajoux & Charles Elson, "*The Art of M&A Due Diligence*"(2000), pp.5

[8] David Baker & Robert Jillson, " *Due Diligence, Disclosures and Warranties in the Corporate Acquisitions Practice*"(1992), pp.7

[9] Phillp, J, Clements, op.cit.(note 1)

[10] David A. Katz &Wachtell, Lipton, Rosen & Katz, op.cit.(note 3)

[11] Alexandra Reed Lajoux & Charles Elson, op.cit.(note 7)

[12] Id.

[13] David A. Katz &Wachtell, Lipton, Rosen & Katz, op.cit. (note 3)

[14] Id.

[15] Id.

[16] Alexandra Reed Lajoux & Charles Elson, op.cit.(note 7)

[17] Id.

[18] Id.

[19] David Baker & Robert Jillson, op.cit.(note 8)

[20] David Baker & Robert Jillson, op.cit.(note 8)

[21] All the information concerning on the Chinese merger and acquisition is based on the summary and analysis of related Chinese laws, regulations and practicing.