Due diligence for joint ventures in China

The debate on how best to enter the Chinese market has been going on since China first became a major recipient of foreign direct investment in the 1990s. Even though many foreign companies prefer the relative security and ease of establishing a wholly foreign-owned enterprise (WFOE), joint ventures (JVs) should not be overlooked as a possible mode of entry to the market even for small and medium-sized enterprises (SMEs), as partnering up with a local supplier, producer or distributor can offer quick market access, established supply chains and proven distribution channels to newcomers to the market.

However, setting up a JV carries inherent risks that have to be identified and addressed before any agreement can be considered. Due diligence therefore needs to be a top priority from the very beginning to correctly assess the viability of the proposed partnership, protect investment and make sure that the other party is able to make the promised contributions.

'The main purpose of any due diligence is to protect the investment by identifying risks connected with a particular transaction.'

From the upcoming EU SME Centre guideline

To help European SMEs gauge what this process will entail in a Chinese context, the EU SME Centre will publish a guideline on due diligence for JVs, mergers and acquisitions in the coming weeks.

If you would like to know more about WOFEs and JVs, please see the following publications, available for free on the EU SME Centre website:

- *Diagnostic kit 'Are you ready for China?': Ways to enter the Chinese market*
- *Guideline: Establishment of a foreign-invested enterprise in China*
- *Webinar recording: How can foreigners establish an office in China? Wholly foreign-owned enterprises and representative offices*

Ticking all the right boxes

At the heart of your due diligence efforts will be a list of all the information necessary for thorough risk assessment. For SMEs, though, time and funds will be particularly constrained and so a balanced approach to the due diligence process will have to be adopted. To facilitate this, a step-by-step approach is outlined in the guideline with the following areas of information highlighted as being particularly relevant for a thorough due diligence process.

1.) General information about the target company
   - Establishment and registration details;
   - Organisational structure;
   - Required permissions and licences;
   - Related local industry policies.

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2.) The target company’s assets
- The company’s real estate (including land use rights and buildings);
- Information on movable assets (machinery, vehicles etc.).

3.) Material contracts
- The key running contracts of the partner - a certain threshold for the material exchange governed by the contract may be useful (e.g., all contracts with a value of above RMB 100,000);
- Information regarding the establishment, validity and execution of each contract.

4.) Labour and social insurance
- Employee details;
- Employment contracts;
- Social insurance issues and pensions.

5.) Intellectual property rights and technology transfer
- All documents related to patents (and their inventors), copyrights, trademarks and other intangible assets, including registered rights and pending applications;
- Lists of IP used but not owned by the company;
- Measures in place to protect from infringement;
- Are there are any pending issues concerning IP?

6.) Financial position
- Information on external financing - loans, options, warrants, securities;
- As well as on internal finances - accounting, payable and receivable accounts, monthly management accounts, financial liquidity plans, bank accounts, accounting staff, product pricing.

7.) Taxation and customs
- Records of company’s tax compliance;
- Use of preferential tax policies;
- Current taxation, tax returns, import and export duties;
- Information on potential future tax fines.

8.) Other considerations
- Product liability;
- Bribery and corruption;
- Environmental and antitrust issues;
- Current and potential legal proceedings.

Bridging the gap

However, apart from the step-by-step approach, EU SMEs should also be sensitive to cultural differences when carrying out due diligence abroad; whereas voluntary disclosure of relevant information is an established method for building mutual trust in western business environments, personal relationships play a much bigger role in China. Awareness of, and an appropriate response to these cultural differences are needed to avoid unnecessary tensions.

Explaining the purpose of your due diligence efforts in detail and as early as possible, including the fact that non-compliance will make a deal impossible, is a first step. It might be helpful to suggest the involvement of a third party – the China office of an international law firm for example – to bridge the gap. Being able to conduct negotiations in Chinese as well as appointing a designated contact person will also help to disperse suspicions on the Chinese side. Finally, the due diligence process should be accompanied with regular meetings between the two parties on a working level. This will provide opportunities to raise questions and explain intricate matters in more detail, thus ultimately contributing to an open and trustful cooperation between the two parties.

Checks and balance sheets

After compiling the documents requested via the due diligence list, the target company needs to send formally verified copies (affixed with the company seal) together with an answered and commented due diligence list back to you for review. If the number of documents is too large or the content especially sensitive, the partner might ask you to examine these directly at his premises.

Next, the authenticity of key documents originally issued by third parties (i.e., public authorities) need to be cross-checked with the help of a Chinese lawyer. This will involve visits to government authorities as well as banks, involved businesses (suppliers, distributors etc.) and any other party that might be able to substantiate the obtained information. Please note that many of these checks are only possible with the consent of the audited company.

Once this has been accomplished, another meeting with the partner, including all personnel involved in the process (your due diligence team and your partner's, as well as investors, legal, financial and tax advisors), should be arranged to discuss and confirm the most crucial issues and to gather further explanations.

At the very end of the due diligence procedure you will have collected a large amount of documents and data, ideally structured and in the form of a due diligence report. This report can then be used as the basis for your next actions. If uncertainties remain, you might want to discuss these with external experts. If certain issues can be settled in a reasonable timeframe, you can urge your partner to 'clean up' before you enter into a partnership. If the risks outweigh the benefits, you can simply walk away from the deal and start looking for a better fit. In any case, you will know a lot more about your partner than you did before and you will therefore be in a much better bargaining position. In addition, much of the information

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gathered will be useful once the JV is established and concerns shift from due diligence to post-transaction operation.

You will be able to find much more information on due diligence in China on the website of the EU SME Centre. Highlights include:

- *Diagnostic kit 'Are you ready for China?': Knowing your partners in China*
- *Webinar recording: How to find the right Chinese partner*
- *Webinar recording: How to manage contract terms and reduce risk in China?*

The guideline 'Due diligence for joint ventures, mergers and acquisitions' will soon be available in the Knowledge Centre on the website of the EU SME Centre. More webinars on legal topics, including due diligence, are scheduled for the coming months. If you have any questions concerning due diligence or any other legal aspect of entering the Chinese market, feel free to post your enquiry directly to our experts.

The EU SME Centre is a support service provider for European small and medium-sized enterprises and business support organisations facilitating market access in China. Financed by the European Union, the Centre provides free of charge, practical information, advice and business tools to better equip SMEs to develop their business and tackle challenges faced in the Chinese market. For more information, including the diagnostic kit 'Are you ready for China?', please visit the Centre's website at www.eusmecentre.org.cn.