Global CPA (Shanghai) Co., Ltd.

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M&A in China

Acquisition of a Business Assets

M&A Process - Asset Deal

PREFACE

An asset acquisition in China is the purchase of a company by buying its assets instead of its shares. In China, an asset acquisition may also involve an assumption of certain liabilities; however, because the parties can bargain over which assets will be acquired and which liabilities will be assumed, the transaction form can be far more flexible in its structure and outcome than a merger, combination or shares purchase.

There are many complex factors to consider for asset acquisition in China. The buyer only acquires the assets and liabilities it identifies and agrees to acquire and assume, subject to any liabilities imposed on the buyer as a matter of Chinese law. This is fundamentally different from a shares acquisition or merger where the buyer acquires all the assets and liabilities (including unknown or undisclosed liabilities) of the target company as a matter of Chinese law.

The ability to pick and choose specific assets and liabilities provides the buyer with flexibility. The buyer does not waste money on unwanted assets and there is less risk the buyer assuming unknown or undisclosed liabilities. However, this also makes asset acquisitions more complex because the buyer has to spend time identifying the assets and liabilities it wishes to acquire and assume.

Rather than having to acquire the entire business operation, investors can simply pick and choose which assets are attractive, take steps to purchase those particular assets, and not have to deal with any other holdings that may be of no particular interest.

CONTENT

1. Qualifications

Instead of going for a share deal, an acquirer should also consider the alternative of an asset deal.

When deciding on share deal or asset deal as the preferred transaction structure, an acquirer should carefully analyze and balance the advantages and disadvantages of both transaction structures.

From the perspective of the acquirer, an asset deal has two main advantages: On the one hand, it gives the acquirer the possibility to do cherry picking and to limit his exposure to liabilities (e.g., product liability risks) or risks (e.g., tax risks etc.) of the business and the selling entity. An asset deal allows the acquirer - again, different from a share deal - to do a so-called "step-up". The "step-up" enables the acquirer to allocate the purchase price to the different assets and thereby reduce the future tax burden by increasing the potential for depreciation.

But an asset deal has also at least two main disadvantages. The most important disadvantage is in many cases (exception: sale out of an insolvency) a conflict of interest between seller and acquirer which makes it more difficult to strike a deal: While the acquirer prefers cherry picking, the seller normally wants to get rid of all liabilities and risks linked to the business that is sold.

But an asset deal also creates more risk for transaction security. While in case of a share deal third party consents are normally limited to applicable government approvals (e.g. merger control) and third parties whose contracts contain a change of control clause, an asset deal multiplies the required third party consents. In an asset deal scenario, any transfer of a liability or contract requires the consent of the counter party - unless the underlying contract allows for such transfer. In case security interests on certain assets have been granted to a financing bank, consent of such bank also has to be granted. And, last but not least, employees can - different from a share deal - object to the transfer of their employment relationships to the new acquirer.

To summarize: An asset deal has a number of advantages for the acquirer, but it makes it normally (much) more difficult to strike a deal with the seller and potentially also increases the risk for transaction security - or underlying commercials.

2. Transfer of Personal and other Labor Issues

The consequences of a company acquisition regarding labor issues depend on whether the purchase was a share deal or an asset deal.

Although an asset deal indeed leads to a change in the identity of the legal entity, this does not mean that commitments resulting from employment contracts and/or work agreements would simply expire or could be easily terminated.

The relevant statutory provision in this respect is existing employment contracts are transferred to the new owner. Hence the purchaser becomes the contracting partner of the employee by operation of law.

3. Transfer of Real Estate

3.1 Implications of the Sale of Real Estate on the Asset Purchase Agreement and the Deal Structure

Whenever real estate (meaning an interest in a plot of land) is sold in the context of an asset deal this has several implications on the asset purchase agreement (APA) and the deal structure:

- The fact that real estate is sold leads to the necessity to notarize the (whole) APA whichmeans higher transaction costs as the notary public will charge fees.

- The real estate needs to be exactly described in the APA which is done referring to the information contained in the respective land register.

- Whenever real estate is transferred the APA will typically include specific representations and warranties relating to such real estate, in particular regarding encumbrances, pollution and contamination of the soil.

- Real-estate can only be transferred by an agreement of conveyance which is an additional agreement distinct from the obligation to transfer real estate and which needs to be notarized as well. The agreement of conveyance may, however, be included in the same notaries deed/APA.

- In case of external financing of the acquisition, lenders might demand the encumbrance of the real estate as security for loans and the seller will usually grant his permission to do so in the APA.

- Real-estate is only effectively transferred once such transfer is registered; such registration can take several weeks.

- As the transfer of real estate cannot, by law, be made conditional upon the payment of the purchase price, such payment is only made once a priority notice which secures the purchaser's claim to the transfer of the real estate is entered in the register.

- Pre-emption rights in favor of the municipality in which the real estate is located might exist and thus one of the conditions for the payment of the purchase price must be the confirmation that no such right of pre-emption exists or it must have been waived.

3.2 General Remarks on Real Estate Law

3.2.1 Interests in Land

In China the interests in land are set forth and defined in the Law of Land Administration. Apart from these interests in land no other interests are recognized. The interests in land are all rights in rem which have an absolute effect against third parties, meaning that all must respect such right.

3.2.2 Land Register

All interests in land are registered in land registers which contain, in particular, information on the owner of the land and its encumbrances. The land registersareadministrated by the district courts. The registration of an interest in land gives rise to the assumption that such interest exists and is held by the person stated in the register thereby making a bonfire purchase from a non-owner possible as long as he is registered.

3.3 The Transfer of Real Estate

Under China law the obligation to transfer an interest in land (the "obligatory contract") is separated from the actual transfer, the conveyance, of such interest (the "real contract").

Therefore, a seller and a purchaser must first enter into an APA which contains the obligation to transfer the respective interest in land. The actual transfer of an interest in land requires a (separate) agreement of conveyance and a corresponding entry in the land register.

3.4 Entry in the Land Register

The interest which is subject to the agreement of conveyance is only transferred if and when the change of the interest (e.g. the transfer of ownership) is registered in the respective land register.

Once the seller and the acquirer have entered into the agreement of conveyance and the change of interest is registered in the land register, the transfer is effective irrespective of the validity of the underlying APA. However, if the APA is invalid, the seller can reclaim the interest on grounds of unjust enrichment.

4. Transfer of Licenses and Permits

With the exception of certain approvals, asset deals in China as such do not require administrative approval. However and other then in share deals, administrative approvals may factually impact the deal with regards the transfer of licenses and permits. Permits can be divided into the following two categories:

Object-related permits

(1) Construction licenses; and (2) Operating licenses for industrial facilities, including all relevant regulatory authorizations which are required to build and operate the facility. In this regard, the authority does not have to approve the transfer when the operator changes in an asset deal.

Personal permits / concessions

Personal permits / concessions cannot be transferred. Instead the buyer has to apply for the necessary permits himself and anew-as the permit often depends on certain personal and professional qualifications, skills, organizational set-ups and specific know how. Another very important personal aspect under certain laws is the reliability of the operator.

In most M&A transactions, both types of permits are relevant and, in fact, there are circumstances under which both types are combined, such as for the power generation in China: For those there are strict requirements in regard of the facilities(object-related) as well as the operator(personal permits).

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5. Third Party Consents

As indicated above under III. 1.1 (Qualifications), an asset deal triggers a large number of consent requirements from third parties - going well beyond the consent requirements triggered by a share deal.

Third party consents may be necessary for an asset deal under mandatory law, corporate law, contractual obligations, for the transfer/assignment of contracts and in case of certain encumbrances on the asset. To highlight some peculiar third party consents:

Most importantly, unless the underlying contract allows for transfer without consent, any contract will only transfer to the acquirer upon consent of the counterparty. The same applies for liabilities - if these are to be transferred to the acquirer. The relevant asset(s) may serve as collateral, may not be (solely) owned by the seller or may be encumbered.

Depending on the security right that has been granted, assets that have been provided as security interest to a financing bank may only be transferred with the consent of such bank. Consents from the secured party must be obtained prior to transfer (examples: title retention / transfer of ownership by way of security, mortgage). While the buyer may still lawfully obtain ownership in such assets under the good faith principle, it will not do so where it had or could have had knowledge over title defects or where securities were listed in public registers (such as for mortgages).

In insolvency proceedings the insolvency administrator has to obtain approvals from the meeting of creditors before disposing of assets from the insolvent company.

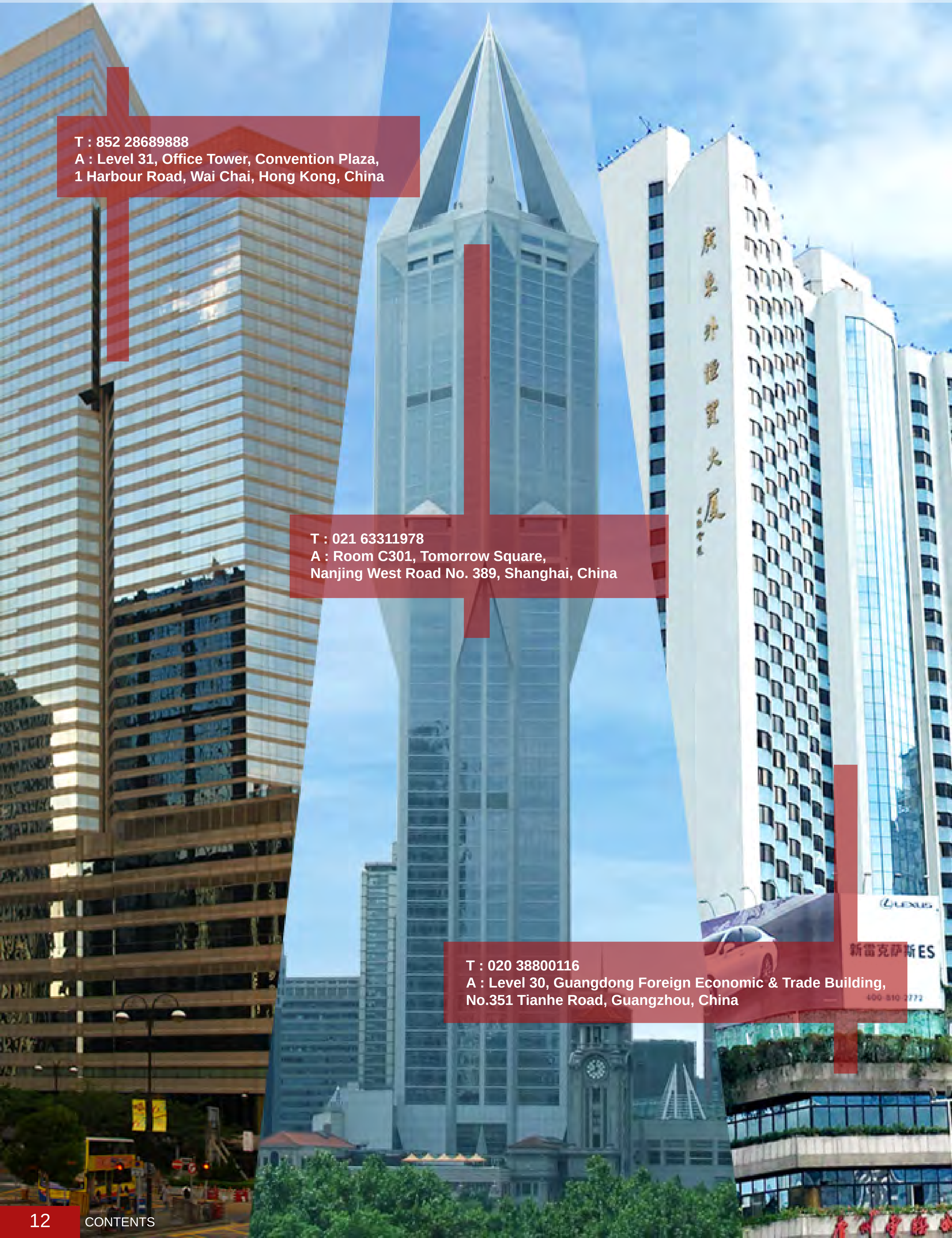
In family run businesses, spouses may have to consent to an asset transfer for the business, even if the spouse is not directly or visibly involved in the business. However, these statutory provisions can be waived by a marriage contract.

The right of employees to object to the transfer of their employment relationship should also not be underestimated. While in most cases employees will have an interest to stay on board, such rule allows key employees an easy way out - without having to observe contractually agreed notice periods.

There are different ways how to deal with necessary third party consents. Of course, third party consents that are either legal prerequisites (e.g. merger control approvals) for closing the deal or that are considered a must by the acquirer for commercial reasons should be agreed as condition precedents to closing. But such treatment will not be practical for most contracts and liabilities.

For these cases, it is common to agree between the parties that, until the required consent has been granted, they will treat each other internally as if the consent had already been granted. In essence, this means that the seller will remain the contact person vis-a-vis the third party in question but that the seller will act upon the instructions of the acquirer. On the other hand, the acquirer will bear all commercial risks linked to this relationship, unless the seller acts in violation of instructions given.

To sum up: In case of an asset deal, the acquirer has to carefully scrutinize the business for necessary third party consents. Such consent requirements have then to be clustered according to their relevance for the deal, and contractual solutions have to be agreed upon protecting both sides against a scenario where required consents are not granted.



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