China Merger & Acquisition

Consideration of Share Acquisition Deal in China

M&A Process - Share Deal

PREFACE

A share purchase is conceptually very straightforward; the buyer simply purchases the outstanding stock of target company directly from the stockholders. The name of your company, operations, contracts, etc. All remain in place, just with new owners.

In a share acquisition, the buyer acquires the target company's share from its stockholders. The target company stays exactly the same—its assets and liabilities unchanged—but with new ownership. It is critically important in a share purchase transaction that the buyer negotiates representations and warranties concerning the target's business, assets, and liabilities so that it has a complete and accurate understanding of the target company.

Share purchase virtually eliminates the need to transfer title (i.e., purchase) to all of the many different assets used in or by the business. It also can eliminate the need to transfer, renegotiate or reapply for things such as permits, utilities, facilities leases and employment agreements. Of course, some contracts may have so-called "change of control" provisions that will require special attention.

Since the target company is simply moving to a new owner, the assets of the target remain unchanged in a share purchase, and most of the assignment and third-party consent procedures that can cause complications or delays in an asset purchase may be avoided. A share purchase does, however, involve a "change of control," so the buyer must identify contracts that require consent. For example, many real estate leases contain "change of control" provisions requiring landlord consent.

CONTENT

1. Identification of Targets 4
2. Preparatory Activities 5
2.1 Options for Transaction Structure 5
2.2 Establishing Transaction Structure 7
2.3 Corporate Structure 8
3. Due Diligence Items 9
3.1 Corporate Formation 9
3.2 Intellectual Property 12
3.3 Share Seal 13
3.4 Tangible Assets 14
3.5 Environmental Due Diligence 18
4. Implementation Issues and Contractual Documents 19
4.1 Necessary Transaction Documents 19
4.2 Mandatory Content 25
4.3 Timeline 26
4.4 Third Party Consent 27
4.5 Liabilities 28
5. Signing and Closing 30

1. Identification of Targets

A successful M&A transaction requires the identification of a suitable acquisition target.

Whether a target is suitable or not depends on the buyer's strategic outlook and expectations vested in the specific project. Based on these presuppositions, the buyer will develop a profile of possible target companies, looking at aspects such as the type of activity, company size, market position, production range, and other economic and specific company-related considerations.

It is especially important to acquire comprehensive and in-depth information when identifying suitable targets. Useful M&A-related services – mainly restricted to the provision of information – are available in the public sector. However, M&A projects are typically implemented with the support of an M&A services provider. Particularly relevant services include strategy development, target finding, due diligence, transaction implementation, and post-merger integration. The specialist fields of law, tax, and financing are at the center of these services.

The question as to whether and to what extent such service providers are integrated in an M&A project depends on the internal professional resources available, experience levels, and the complexity of the project.

2. Preparatory Activities

2.1 Options for Transaction Structure

2.1.1 100% Acquisition versus Joint Venture

Generally speaking, there is no ceiling on the proportion of shares held in China companies by foreign investors. However, restrictions apply for the acquisition of 25% or more of the voting rights if the target's business activities fall within certain sensitive sectors or where such acquisition endangers national security.

While upon the acquisition of all shares in the target company the investor is in full control of the target company, the acquisition of only a portion of the shares in the target company results in a joint venture among the investor and the remaining shareholder(s) of the target company. In a joint venture, the investor will have to leave a certain amount of control over the target company to the remaining shareholder(s) or, depending on the circumstances, may exercise joint control together with the remaining shareholder(s). At the same time, the remaining shareholder(s) still participate in the target company and therefore have an incentive to grow the target company.

Under certain circumstances it may be useful to combine the acquisition of a portion of the shares in the target company with the grant of a call option to acquire additional (e.g. all remaining) shares in the target company at a later stage. The remaining shareholder(s) may require the grant of a put option in return for the grant of a call option to the investor. However, since the development of the target company until the exercise of the option is hard to predict, it is difficult to agree on a fixed purchase price or a pricing formula for the option shares acceptable for both parties.

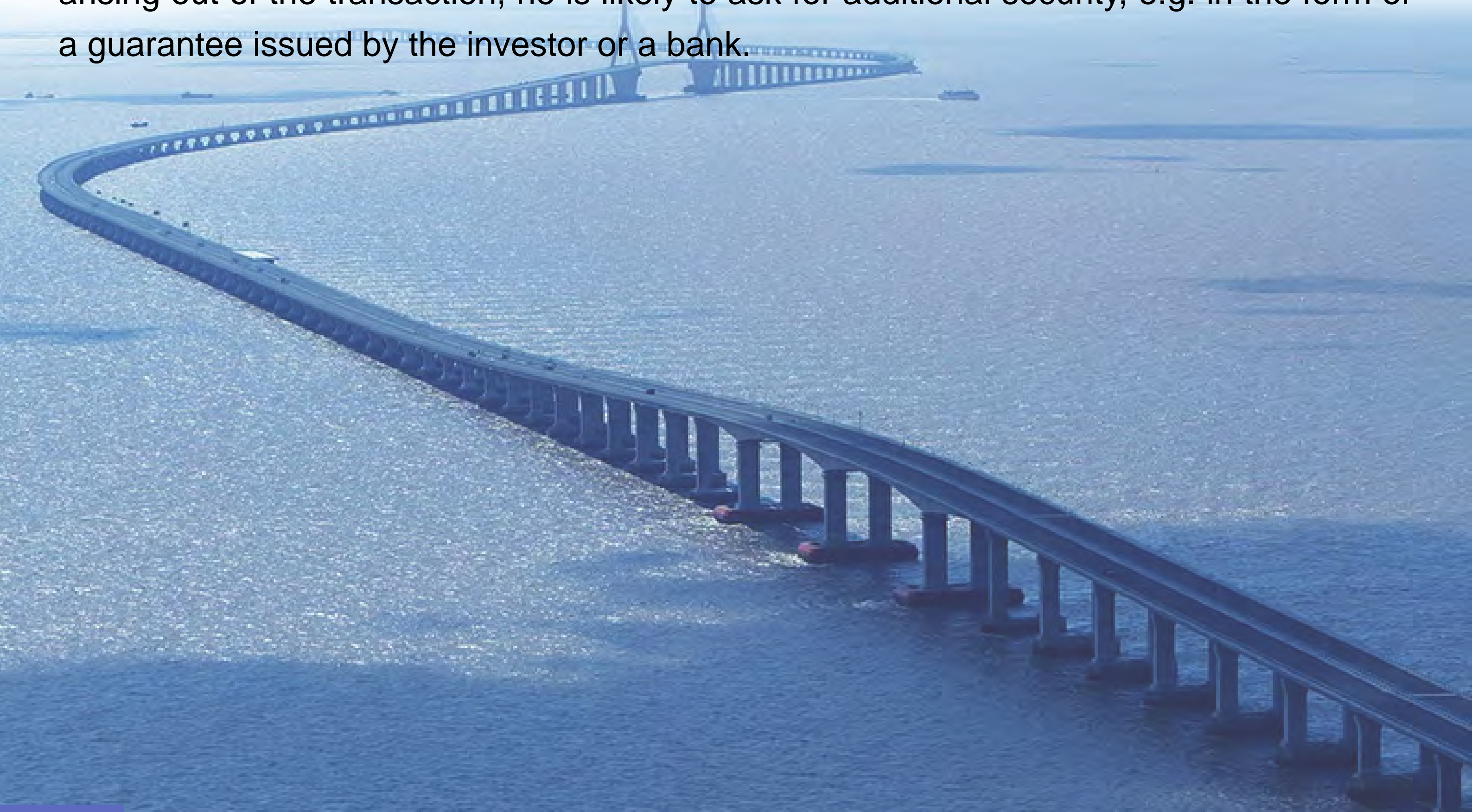
2.1.2 Technology/ Trademarks

Sometimes technology and trademarks used by the target company do not belong to the target company but to the owner of the target company. In this case, to safeguard the continued use of technology and trademarks after the acquisition, the investor needs to in-license the relevant technology or trademark from the owner of the target company.

2.1.3 Direct Acquisition Versus Acquisition by Special Purpose Vehicle

Instead of directly acquiring the shares in the target company, the investor may choose to make use of a special purpose vehicle (the SPV), i.e. a subsidiary of the investor that acts as the acquirer of the shares. This way, the investor can try to insulate himself from the transaction risk.

Another benefit of the use of an SPV, in particular where shares in multiple target companies are to be acquired, is that the acquisition is bundled in the SPV. Whenever the investor wishes to resell the acquired shares at a later stage, he will be able to do so by simply transferring his shares in the SPV. The downside of an SPV structure, however, is that if the seller deems the capital resources of the SPV insufficient to bear the liabilities arising out of the transaction, he is likely to ask for additional security, e.g. in the form of a guarantee issued by the investor or a bank.



2.2 Establishing Transaction Structure

2.2.1 Approvals

The closing conditions often include the granting of approvals by public authorities, or by corporate bodies, e.g. the shareholders' meetings or the supervisory boards of the parties. In addition, the acquisition is subject to review and, in exceptional cases, prohibition if as a result of the envisaged transaction the investor would acquire 25% or more of the voting rights in a China company and such acquisition would endanger public order or safety.

Of course, the investor must meet the requirements of the respective home country's laws regarding foreign investments.

2.2.2 Memorandum of Understanding

The memorandum of understanding (the "MOU") or letter of intent (the "LOI") describes the envisaged basic structure of the transaction which may include the purchase price (fixed purchase price, price range or a price formula), a target closing date, post-transaction management changes, along with exclusivity provisions (clauses that prevent the seller from negotiating with other potential buyers for a specific period of time). Although a MOU or LOI will never cover all aspects of the transaction in full detail, it is an important step in aligning both parties’ expectations. This is of particular importance given that the due diligence that will follow as a next step is an expensive and time-consuming exercise on the part of the investor. Whether or not the MOU or the LOI is legally binding depends on the wording of the individual document.

2.2.3 Preparing an Special Purpose Vehicle: Shelf Company Versus New Company

Where the investor chooses to make use of a SPV, he can choose between two different ways of obtaining an SPV that has so far not carried out any business activities. The investor may either decide to establish the SPV by himself (the "New Company" or NewCo) or he may acquire a ready-to-use shelf company from one of the specialist providers of such companies. While the acquisition of a shelf company will be slightly more expensive compared to setting up a NewCo, it can save the investor time as compared to a NewCo. Therefore, a shelf company is the SPV of choice whenever time is of the essence.

2.3 Corporate Structure

2.3.1 Internal Corporate Structure of the Target Company: Ensuring Sufficient Control Rights

If the investor does not acquire 100 % of the shares of the target company, he needs to ensure that the articles of association of the target company (and, if applicable, the shareholders' agreement/ joint venture contract) provide him with a sufficient amount of control over the target company. Where the target company is a Limited Liability Company, a simple majority of the voting rights in the shareholders' meeting is sufficient to pass resolutions pertaining to the day-to-day business. Fundamental decisions require a 75% majority in the shareholders' meeting.

2.3.2 Integrating the Target into the Investor's Existing Corporate Structure

If the investor exists in the form of a group of companies that share centralized services (such as accounting, IT, etc.) and / or that are parties to a cash pooling agreement, the investor must decide whether the target company shall be integrated into the existing structure of the group.

The degree of such integration will have impact on crucial aspects such as accounting and taxation.

Investors should also take into consideration that any repatriation of profits from China may be subject to capital control, depending on country specific regulation.

3. Due Diligence Items

3.1 Corporate Formation

For the purpose of reducing the scope of the information provided here under, the following outline refers to stock corporations and limited liability companies under China law only.

The review of the corporate formation of the relevant target company or target group of companies is an essential element of any legal due diligence. Such review has to focus, in particular, on the following items:

- formation of the target company itself;
- business scope and business license (if any);
- (major) changes in the corporate structure, including acquisitions, disposals and restructurings;
- chain of title in the target company's shares;
- dominating and profit and loss transfer agreements

Any such review of the target company has to extend to the target company's subsidiaries and/or its affiliated companies which are an (indirect) part of the acquisition. In practice this requires quite often the review of companies existing under the laws of foreign countries. Any buyer has to check with its China legal counsel whether the due diligence on such foreign companies may be undertaken by this counsel itself (if it is an international law firm) or by an independent law firm and, in the latter case, whether such independent law firm is directly mandated by the buyer or indirectly mandated by the (China) law firm.

3.1.1 Formation of the Target Company Itself

The initial questions in a corporate law due diligence have to focus on the validity of formation of the target company itself. The shareholder of the target company has to provide information on the formation as such, in particular the articles of incorporation. Further, it has to be checked whether the target company's shares have been validly subscribed by the founding shareholders. In that context it has to be evidenced that the initial share capital has been effectively paid in and that the shares have effectively been subscribed. Some of this information is generally available in the China commercial register, however, not all.

3.1.2 Business Scope and Business License

Further, there is no ultra virus rule under China corporate law pursuant to which any acts attempted by a corporation that are beyond the scope of powers granted in particular by its articles of association are void or voidable. Therefore a due diligence need not to focus specifically on acts (in particular contracts) which may be beyond such powers granted, even though the target company's management may have violated its obligations towards the company by conducting acts falling outside the scope provided for by the articles of association.

The target company's business scope is, however, of particular importance in business areas regulated by law. If the business scope indicates that the conduct of the target company's business has to be approved by certain authorities, the buyer should pay specific attention to the fact whether any necessary approvals have been obtained, are still valid etc.

3.1.3 (Major) Changes in the Corporate Structure

Any buyer has to validate whether (major) changes in the target company's corporate structure have taken place. This includes, in particular, acquisitions, disposals and restructurings. A buyer has to check whether any changes to the target company's articles association are valid and, in particular, whether such changes have effectively been undertaken in front of a notary and validly registered in the commercial register. Notably with regard to a contemplated acquisition of a (publicly listed) stock corporation it may be checked whether such company was initially established as a limited liability company and whether the conversion to a stock corporation is valid pursuant to the China law regulating the transformation of companies. If so, a corporate due diligence has to be extended to the accomplishment of the provisions of this law.

3.1.4 Chain of Title in the Target Company's Shares

A further essential element of a corporate due diligence is the review of the target company's chain of title as regards its current shareholders. It has to be checked whether any transfer of shares has taken place (either in the context of an increase of the target company's share capital of by virtue of a transfer of existing shares) and whether such transfer is valid. Even though the buyer should always seek for a guarantee in the share purchase agreement that the to-be-acquired shares in the target company do exist and that the seller is the lawful owner of these shares, such guarantee does not render a careful determination of the target company's chain of title superfluous.

Transfers of such types of shares follow different rules and, thus, have to be reviewed separately in the due diligence. A buyer has to note that stock corporation's shares do not have to be chartered.

3.2 Intellectual Property

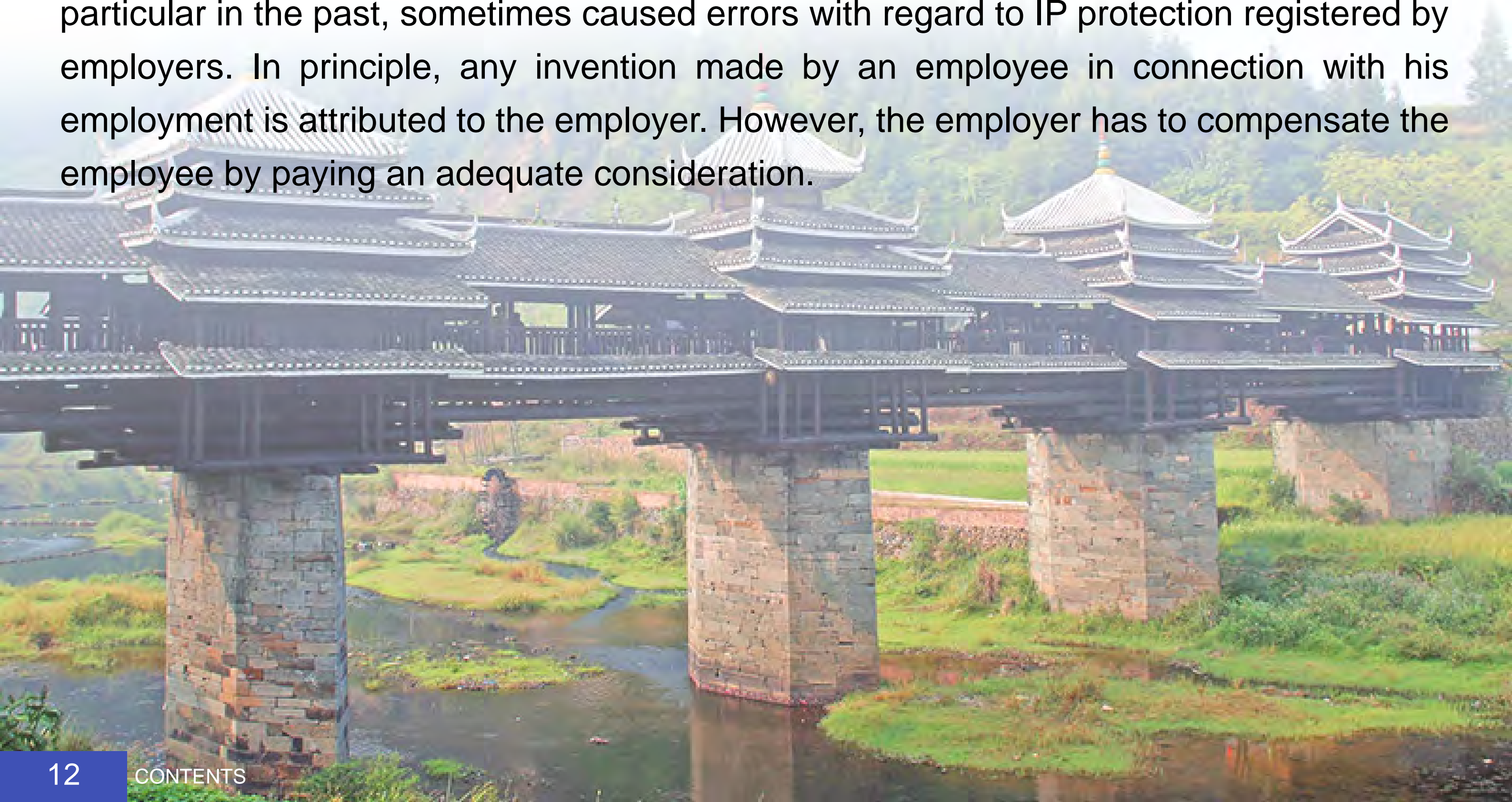
Depending on the industry and relevance for the target business, evaluating the scope and quality of intellectual property (IP) assets may be a very important part of the due diligence review.

Such review usually involves the examination of the ownership, confirmation of the registration status and analyzing the scope of protection, including remaining duration of the terms and applicable countries. Further it may be appropriate to include an assessment of possible risks of invalidation/ cancellation (in particular, pending proceedings, payment of renewal fees, actual use of trademarks) and potential infringement of third party rights (freedom-to-operate analysis).

As other countries, China has a number of laws governing intellectual property rights which cover, among-st others, patents, utility models, trademarks, copyrights, design protection.

In particular, where the target company is part of a company group, the relevant IP rights may be held by the parent company or other specific IP holding company of such group and thus would need to be transferred to the target company before the business is acquired.

It is also noteworthy that China has a specific law on employee inventions which, in particular in the past, sometimes caused errors with regard to IP protection registered by employers. In principle, any invention made by an employee in connection with his employment is attributed to the employer. However, the employer has to compensate the employee by paying an adequate consideration.



For important IP assets it should be verified that the target company has followed those requirements to exclude defects in title regarding patents or utility models and/or financial risks.

In case the target business is believed to have valuable know-how in the form of trade secrets (unregistered intellectual property), the review of the target company's approach as to confidentiality agreements with employees and relevant parties should be considered.

Moreover, as additional part of the IP due diligence, license agreements (license-in or-out) should be checked – including scope of rights granted (exclusive or non-exclusive, scope of permitted use, geographic scope), royalty conditions and termination rights. In particular it would be reviewed whether any change-of-control clauses are included which may constitute a risk for the continuity of the business following the intended share deal transaction. A specific license-related issue in China consists in the risk that, under certain circumstances, a license might be terminated under China insolvency law in case of bankruptcy of a licensor.

3.3 Share Seal

The share deal usually has no consequences on the respective employment relationship.

Employment contracts remain effective and unchanged. A change of shareholders does not give the employer or the employee extraordinary rights whatsoever, including the right to termination. Existing agreements remain effective without exception. Only in the case of senior management, it may be possible that employment contracts contain a change-of-control clause. Such a clause usually makes it possible to leave the company when the majority shareholder is replaced, against valuable consideration.

3.4 Tangible Assets

The main focus of the assets due diligence is typically to establish whether the target company is owner of the material assets of the business or has the right to use such assets as well as whether there are any third party rights or encumbrances that restrict the use of the material assets. As a starting point, the buyer should get an overview of the scope of assets belonging to the target business based on the balance sheet and assets lists provided by the seller as well as site visits.

3.4.1 Real Estate

The key source for the real estate due diligence is the land register kept at the relevant local government department. Land-use right as well as rights of third parties in the real property such as security interests or easements, have to be recorded in the land register to become effective. Accordingly, current excerpts of the land register in respect of the relevant properties are a standard item of the due diligence questionnaire.

A bonfire purchaser is protected with regard to the use right record in the land register as well as the absence of in-rem rights not recorded in the land register. However, it is important to note that this protection does not apply in case of a share deal since the properties themselves are not transferred but remain owned by the target company.

But the “bona fide purchaser” protection may still be relevant in respect of property transactions entered into by the target company.

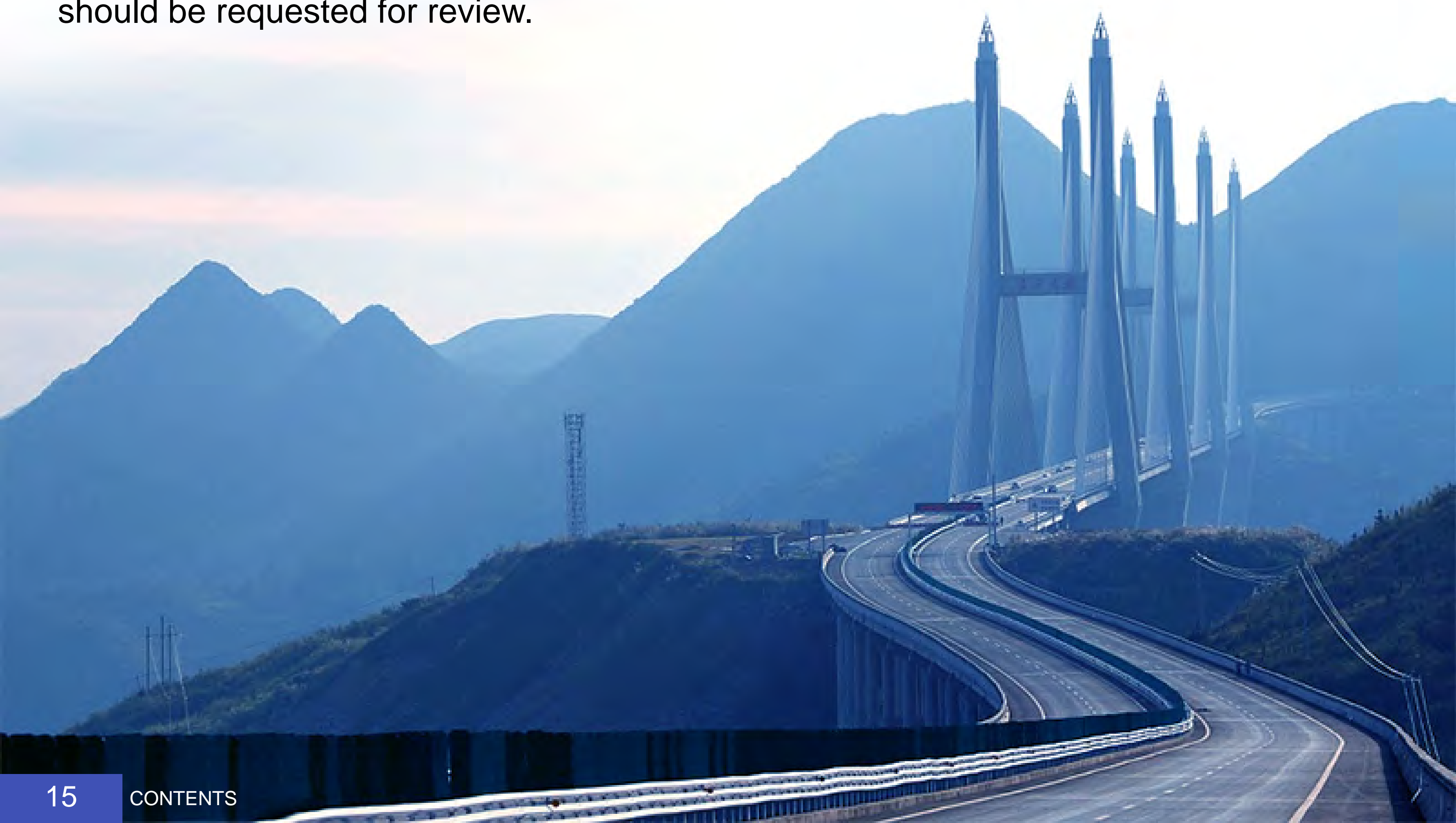
Likewise, it has to be noted that mere contractual rights (as opposed to rights in-rem), such as a lease or other use right, granted by the target company to a third party cannot be entered into the land register and are generally not covered by the aforementioned bonfire protection.

3.4.2 Movable assets

The scope of due diligence review with regard to the moveable assets has to be carefully defined.

A comprehensive title analysis would be a disproportionate effort. In China there is no public registry in respect of rights and encumbrances in movable assets and which may enjoy good faith protection. Also, the possession of assets is not a reliable indication of title or other interest in assets. While a bona fide acquisition of ownership may generally be possible, this protection does not apply in case of a share deals far as the indirect “acquisition” of the relevant assets by the buyer is concerned. Accordingly, an in-depth review would usually be limited to selected assets which are of significant importance for the continuation of the target business. Apart from this, the buyer would rely on the information given by the seller as well as contractual warranties in the share purchase agreement.

Further, it is quite common in China, especially in respect of mass goods that supply is made under retention of title. In such case the supplier retains title to the goods delivered until payment of the purchase price or other events defined in a contractual agreement or under statutory law. In order to analyze the use of such arrangements by the target company, all credit contracts, other financing agreements as well as security agreements should be requested for review.



3.4.3 Lease Agreements

In case important assets of the business – immovable or movable – are leased by the target company, a thorough review of the relevant lease contract is required to identify potential issues for business continuity and financial risks. Such review typically focuses on:

- rent conditions, including right to increase the rent;
- particular use restrictions;
- maintenance and repair obligations;
- rights and obligations upon termination (e.g., removal of fixtures and fittings, obligation to restore the original condition, compensation etc.); and
- very importantly, the duration of the lease as well as termination rights.

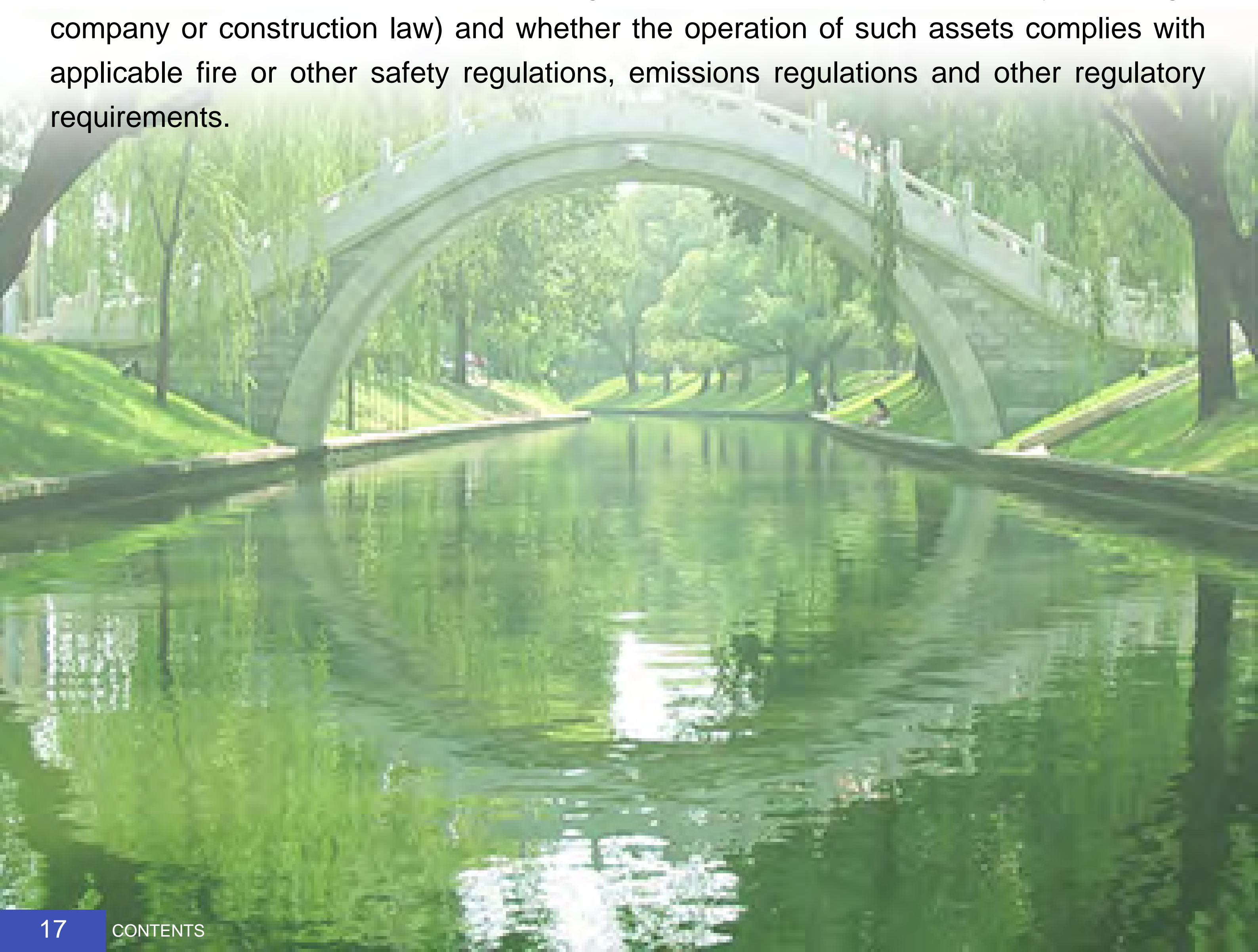
As for all long-term contracts, it is in particular of utmost importance to review whether the relevant agreement includes a change-of-control clause, which would allow the counter party to terminate the contract (or to exercise other special rights or options) in case of an ownership change in the target company resulting from the intended share deal. Such change-of-control clauses may pose a particular risk for the business continuity and should, in such case, be resolved through arrangement with the relevant contract partner or appropriate safeguards in the transaction contract.

3.4.4 Permit Situation

Depending on the risk profile of the relevant business and assets, it may be appropriate to include an in-depth review of the permit situation in the due diligence exercise.

With regard to the real estate, it should be verified that zoning regulations including the zoning plan, if applicable, are complied with. The land must be properly zoned (e.g., as commercial zone or industrial zone, as applicable) to allow for the activities conducted by the target business. It may also be reviewed whether the existing buildings comply with the conditions of the building permit. If an expansion of the business needs to be considered, construction or other regulatory restrictions that may hinder such plans would be carefully reviewed based on the construction permit, the zoning plan and other relevant regulations.

Moreover, especially with respect to production facilities and machinery, it should be reviewed whether all required operating permits have been obtained by the target company or construction law) and whether the operation of such assets complies with applicable fire or other safety regulations, emissions regulations and other regulatory requirements.



3.5 Environmental Due Diligence

Environmental due diligence is both a combined legal and technical exercise that is performed to assess liability risks which can be very substantial. If appropriate based on the risk profile of the target business, the technical evaluation usually involves a comprehensive investigation into both historical and current environmentally sensitive activities of the target company, review of relevant documents (including on the use of the properties and machinery, reviewing environmental files maintained by the site owner and regulatory agencies as well as relevant correspondence), on-site visits and interviews as well as, if deemed necessary, an in-depth site evaluation including, for example, soil and groundwater sampling.

Generally, there is joint and several liability of different parties for necessary damage prevention measures, remediation measures or, under certain circumstances, even the cost of investigation measures: In particular the party that caused the (imminent or actual) contamination or pollution and the owner of the relevant property or the party who is in actual possession (irrespective of whether they caused the contamination or not) may be held liable. Even former owners could be held liable if they knew or should have known about the contamination. With regard to the due diligence scope, it should be kept in mind that the target company might also be liable for their legal predecessors (e.g., in case of a merger) as well as for subsidiaries under its control.

The competent authorities have broad administrative discretion in choosing the party that shall be held accountable. However, the party who was required to bear the cost of the relevant measures under applicable environmental law may take recourse and claim compensation from other liable persons. In view of this environmental liability framework, the buyer has a strong interest in including strict indemnification provisions in the share purchase agreement ensuring that solely the seller shall be responsible for any environmental issues that have been caused or occurred prior to the closing of the transaction. However, such arrangement is only binding among the parties of the transaction and does not affect the governmental agency's discretion to require any of the relevant parties to conduct the necessary measures or bear the associated costs.

In order to evaluate the practical risk of environmental liability, apart from the technical audit results, usually relevant environmental files, in particular documents regarding past or pending investigations or proceedings of authorities or in respect of relevant third party claims, should be requested for due diligence review.

4. Implementation Issues and Contractual Documents

Once the due diligence exercise has confirmed the acquirer's interest to move forward with the transaction, the parties proceed to the negotiation phase which is dominated by negotiating the definitive agreements for the transaction, first and foremost the share purchase agreement.

During this phase, the parties will start considering items relevant for the implementation phase of the transaction.

4.1 Necessary Transaction Documents

In share deals in China, the parties usually sign or exchange all or some of the following documents between the start of the transaction process and the completion of the transaction:

- Confidentiality Agreement;
- Letter of Intent/Offer Letter;
- Share Purchase Agreement;
- (Local) Share Transfer Agreements;
- Ancillary Agreements (e.g. Transitional Services Agreement).

It is customary in China that the seller prepares a first draft of the contractual documentation.

This is in particular true for transaction processes conducted as an auction, which usually have multiple interested parties participating until the final stages of the process. Otherwise, the seller would not be able to adequately compare the different offers, as an important part of the offer is the contractual documentation. In individual deals – usually in a situation where a small to medium sized seller sells a business to a larger, more seasoned acquirer – the investor, who often has the capacity to prepare the documentation in-house, may request to prepare the first drafts, as this gives it an advantage over the seller. There appears to be a tendency that a smaller to medium sized seller accepts such request, mainly in order to keep its transaction costs down.

English is widely accepted as the contract language for M&A transactions in China, in particular in larger transactions, in auction processes or if the seller intends to attract foreign investors as well. This may differ in cases of a small to medium sized, not very seasoned seller who feels more comfortable negotiating the contractual documentation in China. In most cases, however, such transactions are pure domestic transactions (i.e. both China seller and acquirer). There is no legal requirement in China to have bi-lingual agreements which include a Chinese version of the text.

Under China law, most of the transaction documentation does not require notarization.

However, there are certain significant exceptions to that rule, e.g. agreements with respect to the sale and transfer of shares in a limited liability company.

4.1.1 Share Purchase Agreement/ Share Transfer Agreement

The main contractual document of a share deal in China is the share purchase agreement which governs the relationship between the seller and acquirer, in particular the sale and transfer of the shares and the representations and warranties given by the seller in connection with the sale of the shares. Sellers will sometimes require that an additional share transfer agreement is signed at the time of the consummation of the transaction to actually transfer the shares.

They feel to have more control over the share transfer until the date the transaction is consummated, as the transfer requires an additional signature by the seller. If there is no separate transfer agreement, the transfer of the shares is triggered – after all conditions precedent are fulfilled – by the acquirer paying the purchase price for the shares on the date the transaction is completed. Sellers often dislike this "auto pilot" scenario when transferring their shares.

In more complex transactions, when not only the shares of one legal entity are transferred, the share purchase agreement is often structured as a master share purchase agreement with a number of (local) share transfer agreements. The typical scenario in which a master agreement concept is used is that of a larger group selling a business which is operated by multiple legal entities throughout the group with these entities being owned by different group companies. For tax reasons, the seller will often not consolidate these entities prior to closing into a sub-group solely being comprised of the business to be sold. In this case, the ultimate parent company signs the master share purchase agreement on the seller's side. The master agreement sets out the rights and obligations applicable for the transaction and the transaction is implemented by the execution of multiple (local) share transfer agreements by the relevant group companies of the seller's group. Those (local) share transfer agreement are designed to only implement what has been agreed on master agreement level and, in particular, do not contain any additional rights or obligations for the parties (e.g. separate representation and warranties).

4.1.2 Other Transaction Documents

Besides the (master) share purchase agreement and the (local) transfer agreement, the parties will sign or exchange some or all of the following documents:

Confidentiality Agreement

At the outset of the transaction, the parties will sign a confidentiality agreement. Besides the standard provisions that the acquirer keeps the information received in the course of the transaction process confidential, a confidentiality agreement may contain provisions that prohibit the solicitation of employees of the target company or rules on how to conduct the transaction process.

The provisions on the conduct of the transaction process should not be underestimated. Under China law, negotiating in bad faith and terminating advanced negotiations without any grounds may under certain circumstance lead to a liability of the respective party for, generally, frustrated expenses and foregone opportunities of the other party. To preserve the greatest possible flexibility for the parties, the confidentiality agreement should explicitly provide for a right of the parties to terminate the transaction process at their sole discretion.

In addition, it has become more and more common in China that sellers try to agree with an acquirer already at the stage of the confidentiality agreement that all information contained in the data room will be deemed disclosed against the representations and warranties, thereby limiting the seller's liability accordingly. The sellers try to leverage the competitive situation in which most transaction processes will be in at the time of the confidentiality agreement. That concept is, with certain qualifications, market standard in China, but usually negotiated in connection with the share purchase agreement.

Expression of Interest

In sale processes conducted as auctions, in more complex transactions or in processes conducted by seasoned sellers, access to the data room is often conditioned on anon-binding written expression of interest by the acquirer based on some high-level financial information or an information memorandum. Such expression of interest usually contains an indication of the purchase price. This indicative offer letter is usually complemented by a final or binding offer letter after the completion of the due diligence. In the final offer letter, the acquirer is required to set out both the commercial and the legal terms (i.e. the acquirer needs to provide a mark-up of the draft share purchase agreement provided by the seller) on which it would be prepared to sign the transaction. The binding offer is generally the first binding commitment by the acquirer with respect to the terms and conditions of the transaction. Very rarely, the transaction is signed on the basis of a final offer letter. It usually sets the stage for the final negotiations.

Letter of Intent

In individual transactions, a letter of intent may be signed as an intermediate step in the transaction process. With its non-binding nature, the character of a letter of intent is similar to an indicative offer letter, except that the letter of intent is usually signed by both parties. In addition, a letter of intent is usually more detailed than an indicative offer letter, as the letter of intent sets forth those topics for which the parties have reached an understanding (e.g., purchase price, transaction structure).

While the letter of intent is legally non-binding and, if signed prior to the due diligence, usually subject to the findings in the due diligence, it has a strong influence on the succeeding negotiations of the definitive agreements. In practice any deviation from the terms agreed in the letter of intent requires good arguments – usually material findings in the due diligence.

Therefore, signing a letter of intent prior to the due diligence phase in a share deal will be more in the interest of the seller rather than the acquirer.

Ancillary Agreements

Finally, the parties in an M&A transaction often sign a significant number of ancillary agreements. The nature and the topics of these ancillary agreements are transaction-specific (e.g. retention agreements for key employees, license agreements etc.).

Among the ancillary agreements, transitional services agreements are quite common when the sale of the shares was preceded by a carve-out of the business from larger operations of the seller into a newly set-up company. In this scenario, the seller group will usually provide certain services or perform specific overhead functions (e.g. human resources, legal, treasury) until the transaction is consummated, as it is not an efficient allocation of (financial) resources to set-up the respective functions at the target company prior to the transaction being sufficiently certain.

In addition, if the shares are sold to a strategic investor, setting-up the overhead functions may not be necessary at all, as the target company usually uses the acquirer's overhead functions going forward. To avoid any disruptions after the completion of the transaction and to bridge the time until the respective function is set-up at the target company or the target company is integrated into the relevant processes of the acquirer, sellers are often prepared to provide certain of these services at cost for the target company and the acquirer (in particular, human resources and payroll). The transactional services agreement will govern the rendering of these services.

It should be noted, however, that not all overhead functions and shared services can be provided by the seller post-closing – e.g. the seller will not be permitted to continue as treasury function for, or provide legal services to, the target company after completion of the transaction.

4.2 Mandatory Content

China's statutory law does require mandatory provisions to be included into the share purchase agreement. For the share purchase agreement to be a valid contract, it needs to contain provisions on the object of the sale (i.e. the shares) and needs to set forth the purchase price for which the shares are transferred – so called essentially negotiate, and must apply to the Chinese law.

Therefore, a share purchase agreement under Chinese law usually contains the following topics and issues in addition to the description of the sale and the stipulation of the purchase price:

Seller's Representations and Warranties

In addition to a guarantee covering title to the shares, the seller will usually give guarantees with respect to certain aspects of the business depending on the nature of the business (e.g. financial statements, material assets, intellectual property rights, certain employee matters etc.). Less common than in other jurisdictions is the blanket guarantee that the seller has provided all relevant information to the acquirer. In particular seasoned or well-advised sellers will vigorously resist a guarantee to this effect.

Seller's Liability

The provision on seller's liability contain detailed provisions limiting its liability in case of a breach of the representations and warranties and provide specific procedural rules the acquirer needs to observe when claiming damages from the seller. Whether lost profits are to be reimbursed by the seller is often highly disputed. Under Chinese law, seller's liability for fraud, intentional misrepresentation and the like is unlimited by statutory law and cannot be limited by contract.

Seller’s Covenants

For the period between signing of the share purchase agreement and completion of the transaction, the acquirer has an interest that the seller is no longer free to conduct the business of the target company at its discretion, in particular that is does not act detrimental to the acquirer’s interests. Therefore, the share purchase agreement usually subjects certain extraordinary measures with respect to the business to the prior consent of the seller. These restrictions need to be balanced against the prohibition to consummate a transaction prior to having obtained merger control clearance, as extensive influence on the day-to-day business by the acquirer is seen as a prohibited (premature) consummation of the transaction.

Separation Matters

The share purchase agreement will contain various clauses on items under this heading which are required to separate the target company from the seller group. The termination of corporate agreements with the seller or its affiliates is an important part of these provisions, as those contracts cannot or should not continue after the consummation of the transaction. They will be replaced, to the extent necessary, by newly executed transitional services agreements. In addition, if the target company is financed by the group (e.g. the target company is part of the group cash pool, a financing vehicle of the group has issued guarantees on behalf of the target company, etc.), the financing ties to the seller group need to be severed no later than closing.

4.3 Timeline

The transaction process is mainly steered by the parties to the transaction and third parties, in particular regulatory authorities, will come into play only after the signing of the share purchase agreement. Therefore, the timeline for the negotiation of the contractual documents heavily depends on the interests of the parties. Experience tells that negotiating definitive agreements can take from a couple of weeks – usually in competitive auction processes where the leverage of the acquirer is limited and the final offer letter provides a sound basis for the final negotiations – until well over a year if the target company is not a highly sought after asset.

4. 4 Third Party Consent

4.4.1 Internal Consent Requirements

Depending on the corporate structure of the seller, its articles of association or internal rules of procedure may require that M&A transactions are approved by certain of its corporate bodies or internal committees. In smaller companies, the board of directors or the shareholder assembly may have to approve all sales of shares of a subsidiary. In larger companies, M&A transactions usually have to be approved at senior management level – for smaller transactions with a purchase price below a certain threshold, this may be an investment committee, for larger transactions this is usually the executive board and, in certain circumstances, the supervisory oared. At least if the seller is a stock corporation, the shareholder assembly usually does not have to approve a M&A transaction, except in rare circumstances, e.g. the M&A transaction comprises a divestment of substantially all of the business of the seller.

At target company level, the articles of association sometimes provide that a sale of the shares requires the approval of the target company. While this requirement usually applies only to the actual transfer, any such requirement needs to be identified early on in the due diligence and taken care of in the negotiations of the share purchase agreement.

4.4.2 External Consent Requirements

Typically, merger control clearance is required for a M&A transaction. In addition, the China government may block a transaction for reasons of homeland security. Finally, for specific industries, e.g. Health care, other regulatory requirements may apply.

In case the target company or the seller has a credit facility or other financing which is secured by the shares or the assets of the target company, the sale of the shares usually requires the consent of the financing bank, as the shares and/or the relevant assets need to be released no later than at the day of completion of the transaction. Any such requirements should be identified early on in the due diligence, as dealing with the bank may be burdensome and time consuming.

4.5 Liabilities

The seller and acquirer have opposite interests with respect to the liabilities of the business to be sold. While the seller wants to transfer all liabilities to the acquirer, the acquirer intends to assume none, or only a limited number, of the liabilities.

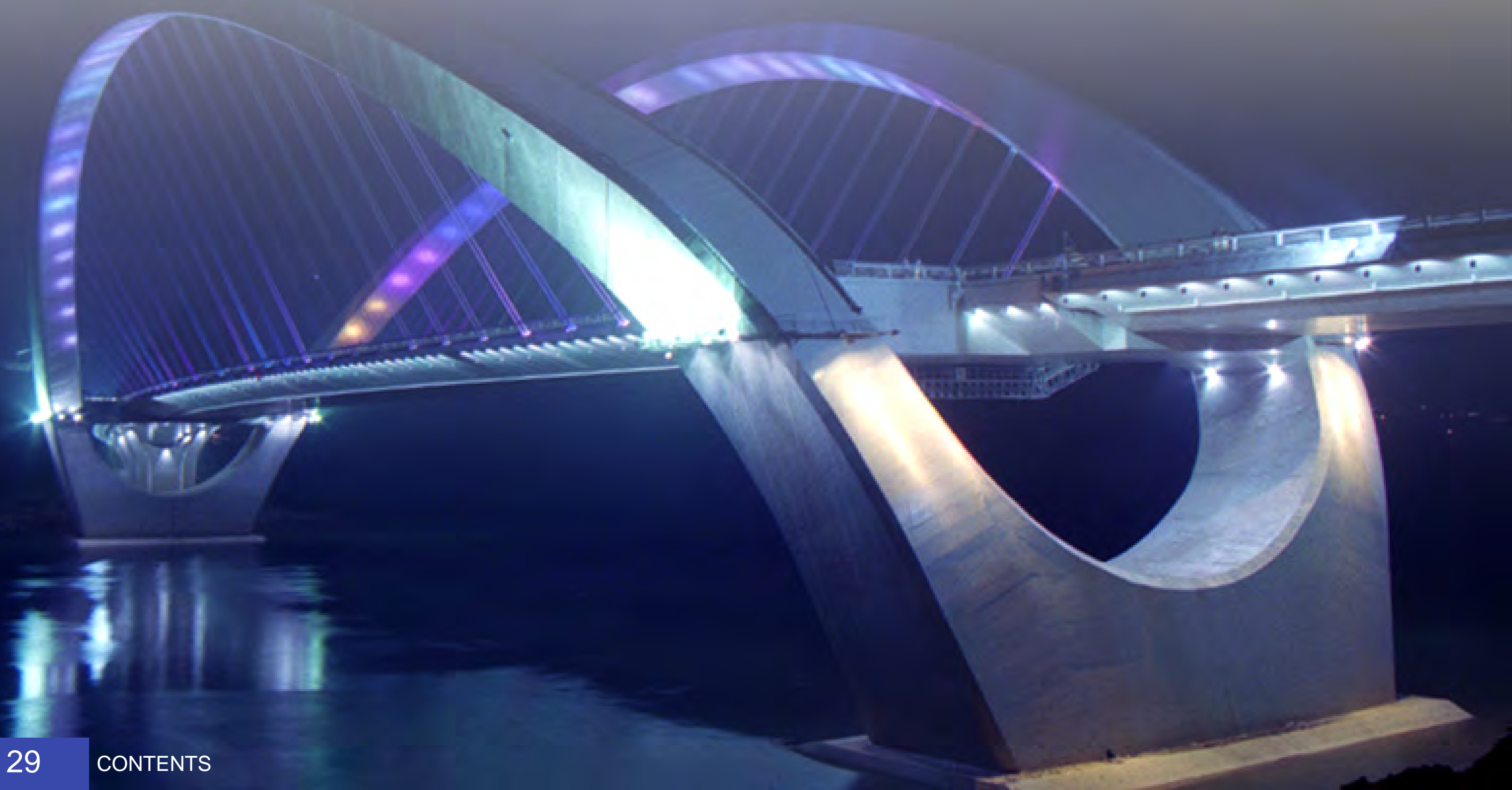
In a share deal, there is no choice. The transfer does not comprise individual assets and liabilities, but only the shares of the target company which operates the business. Therefore, the liabilities of the business stay where they were – in the target company –and the acquirer is stuck with the legacy of the target company, including all liabilities. To avoid this result, the acquire would have to agree with the seller an indemnity that seller indemnifies acquirer for all pre-closing liabilities. While possible under Chinese law, a general indemnity of this kind is almost none-existent in China M&A transactions in the form of a share deal.

The representations and warranties of the seller provide protection for the acquirer, as they cover liabilities arising from situations existing prior to the signing of the share purchase agreement (e.g. product liability claims for products sold during the period the seller was the owner of the business to be sold – for details see below). This protection is, however, significantly limited due to the limitations applicable to the liability of seller for a breach of representations and warranties, in particular the customary exclusion of the liability of the seller in case the acquirer is aware of the situation constituting the breach. Therefore, the most relevant situation – a finding in the due diligence – is not covered by the liability of the seller for a breach of the representations and warranties it has given in the share purchase agreement.

As an exception to the rule, an indemnity for pre-closing tax liabilities is very common. This indemnity usually leads to taxes levied on the target company for the period before the consummation of the transaction being borne by the seller and such taxes for the time after the day of completion being for the account of the acquirer. Less often, the seller will agree to an indemnity for environmental liabilities resulting from decontamination stemming from the period prior to the completion of the transaction. This indemnity is usually heavily debated and contains various qualifiers, as environmental clean-up obligations are in most cases very costly.

Beyond these two items, the parties may agree to different specific indemnities based on the facts of the individual transaction – often due to findings in the due diligence.

Depending on the characteristics of the target company, the treatment of product liability claims for products sold during the period the seller was the owner of the target company may become a fiercely negotiated issue. The seller will often take the position, product liability claims are part of the general risk of operating a business and, therefore, should not be part of any representation, warranty or indemnity. There is no general practice in China how to allocate legacy product liability risk – it largely depends on the leverage of the parties. If the seller accepts liability for product liability claims for products sold prior to closing, the parties usually agree on a representation or warranty. An indemnity for such product liability claims is less frequent and, if at all, seen mostly in cases where there is a history of claims against the target company for product liability.



5. Signing and Closing

After the parties have agreed on the share purchase agreement, they will usually seek to proceed to signing as soon as possible after having obtained internal approval for the negotiation results. While the need for such internal approvals is generally accepted, a seller will much appreciate it, if the acquirer has obtained the required approvals on the basis of close to final documentation and is able to instantly proceed to signing, as this will shorten the “time of uncertainty” between finalization of the negotiations and signing to an absolute minimum.

The share purchase agreement is usually signed in written form by authorized signatories of the parties. Those authorized signatories may be officers of the parties (e.g. managing directors, board members), other generally authorized officers or employees or other persons specifically authorized by individual power of attorney. While a signing by electronic copies exchanged by fax or e-mail would be sufficient and is quite common for preparatory documents (e.g. confidentiality agreements or letters of intent), the share purchase agreement itself is usually signed by the signatories in person with physical originals being exchanged.

Affixing a corporate seal next to the signatures is required and usually done in China.

In case there are no conditions precedent which have to be fulfilled prior to completion of the transaction, signing and closing will take place at the same time. If conditions precedent have to be fulfilled (e.g. merger control clearance), the parties will reconvene for closing once all such conditions precedent have been fulfilled.

At closing, the transfer of the shares of the target company takes place either automatically if signing and closing happen at the same time or if so agreed in the share purchase agreement or upon signing of a share transfer agreement against payment of the purchase price. Typically, the purchase price is paid in cash by wire transfer to an account of the seller without anything further to pay attention to. For any other form of consideration, e.g. shares, consideration in kind, specific transfer requirements may have to be observed.

After all actions at closing have been successfully taken, the parties will often record the fulfillment of the conditions precedent for closing and the completion of the closing actions in a closing protocol or closing confirmation. In this document, the parties also confirm for the benefit of each other that closing has taken place. A closing protocol/closing confirmation is required neither by statutory law nor otherwise for the transfer of the shares to take effect.

Signing such a document is not market standard but nevertheless quite common in China, in particular in larger and more complex transactions with, e.g., a number of closing conditions like merger control clearances in multiple jurisdictions. The main purpose of a closing protocol/ closing confirmation is to have a confirmation that both parties consider the transaction completed. This may help in a post-closing litigation in case one of the parties then questions whether all closing conditions had been fulfilled prior to closing or that all closing action had been taken. In addition, a closing protocol/closing confirmation serves as a document of reference which contains the complete documentation for the transaction for the period after the signing date until the completion of closing.

Hong Kong Office

T : 852 28689888
A : Level 31, Office Tower, Convention Plaza,
1 Harbour Road, Wai Chai, Hong Kong, China

Eastern China Office

T : 021 63311978
A : Room C301, Tomorrow Square,
Nanjing West Road No. 389, Shanghai, China

Southern China Office

T : 020 38800116
A : Level 30, Guangdong Foreign Economic & Trade Building,
No.351 Tianhe Road, Guangzhou, China