

Morgan Lewis

**M&A ACADEMY: CROSS-BORDER
ISSUES: COMPLIANCE,
EMPLOYMENT, AND WHAT COULD
POSSIBLY GO WRONG IN M&A
TRANSACTIONS IN CHINA**

K. Lesli Ligorner

Todd Liao

March 17, 2020

© 2020 Morgan, Lewis & Bockius LLP

Agenda

- **The China Risk Factors in M&A Transactions**
- **FCPA and Anti-Corruption Compliance Due Diligence Issues**
- **Employment Due Diligence Issues**
- **PRC Cybersecurity Law and Data Privacy Issues**
- **Other Legislative Updates**

M&A Due Diligence: The China Risk Factors

- Restricted access to reliable public and private data
- Can you rely on Chinese seller's reps and warranties?
- Separate books and records, contingent and hidden liabilities
- Corruption risks index, guanxi and gift culture
- Rampant nepotism, internal fraud and conflict of interest
- No "at will employment", pro-employee laws, inconsistent and selective enforcement, increasingly more litigious and rights-conscious Gen-Z employees
- Constantly changing laws, and ever-increasing regulations and heightened enforcement actions

FCPA and Anti-Corruption Compliance Issues

A Case Study

- US-listed company
- Target is a private company converted from State-owned enterprise
- Deal counsel focus on corporate legal due diligence, no separate FCPA due diligence done
- Industry involved in numerous other FCPA investigations
- Missed red flags on risky business model, lower-end market competing mainly on price, and reliance on third party vendor - local design institutes (LDIs)
- Key compliance red flags buried in corporate documents
- Corporate governance at the target lacking

FCPA and Anti-Corruption Compliance Issues

The source of compliance red flags:

- Internal or external whistleblower reports
- Management interviews
- Audit reports
- Third party relationships
- Record of government investigations or inquiries

FCPA and Anti-Corruption Compliance Issues

Timing on compliance due diligence and importance of separate team /work stream

Should you insist on management interviews?

- Risk-based approach
- Selection of interviewees (functions, levels)
- Who should conduct the interviews and the language of the interviews?
 - Flying lawyers in from abroad
 - Local Chinese lawyers
 - Dual qualified lawyers

Should you insist on transaction testing?

- Why is this different from financial due diligence?
- Cooperation of the target and your business team
- How deep do you dive?

Morgan Lewis

Key Legislative Updates

The 2018 National People's Congress ("NPC") introduced a series of changes designed to enhance the central government's anti-corruption campaign

- Supervisory agency reform:
 - Creation of National Supervisory Commission ("NSC") – *public servants*
 - Creation of State Administration for Market Regulation – *market players*
- Legislative development:
 - Supervision Law, effective on March 20, 2018
 - Anti-unfair Competition Law ("AUCL"), effective on January 1, 2018, revised on April 23, 2019

Key Legislative Update

Jurisdiction of Supervision Law

- Covers activities and offenses committed by public servants in connection with performing their public duties
- The scope of “public servants” is broader than persons subject to the CCP’s previous supervision system
e.g., in January 2018, a contract worker of a local urban management agency in Guangzhou was investigated by the local supervision commission for taking bribes. The individual in this situation was not a formal civil servant or CCP member.
- Excluding nonmanagerial staff of SOEs and public institutions
e.g., teachers and doctors without managerial positions

Investigative Powers of NSC

- Private sector businesses and their employees may be required to provide information or evidence to assist supervision commissions’ investigations
- An individual employee or officer of a company may be detained by supervision commissions if they are suspected of giving bribes to public servants.
e.g., in the second half of 2017, a local supervision commission in Zhejiang province detained a shareholder of a local privately owned company in connection with an investigation of a government official. The shareholder has reportedly destroyed certain evidence and colluded with other people in responding to inquiries from the local supervision commission.

Key Legislative Update – Anti-Unfair Competition Law

Certain payments to counterparties of a transaction no longer presumed to be bribery. Applicability of AUCL expands to entities or individuals who may take advantage of their positions, authority or influence over a transaction

Amended definition of Commercial Bribery

Bribery committed by an employee of a business operator would be imputed to the employer, unless proven otherwise (e.g., the company has a robust compliance program)

Corporate liability vs. Individual liability

Business operators may offer discounts to their business counterparties or pay commissions to intermediaries, all of which shall be recorded (e.g., discounts or commissions) in the books and records truthfully and accurately by all parties involved.

Exception & Books and Records Requirement

Enhance enforcement penalty

Fines increased in amended AUCL Law ranging from **RMB 100,000 to RMB 3 million**, confiscation of illegal gains, and in the worst case scenario, revocation of business license.

Effective Jan. 1, 2018

Morgan Lewis

Commercial Bribery – Select Enforcement Cases in Shanghai (from June – Dec. 2019)

Date	Enforcement Agency	Company	Violation	Penalty
2019-05-07	Shanghai Jing'an AMR	Alfa Wassermann (Beijing) Pharmacy Consulting Co., Ltd.	Gave speaking fees to physicians to seek competitive advantages; the speeches in question never actually occurred	Fine of RMB 480,000
2019-08-30	Shanghai Jing'an AMR	Shanghai Nexen Tire Sales Co., Ltd.	Gave rewards to staff of non-franchise distributors in form of trips to Thailand to seek business opportunities and competitive advantages	Fine of RMB 120,000
2019-08	Shanghai AMR	Po-Li Food Industry (Kunshan) Co., Ltd.	Gave kickbacks to staff of supermarkets like Carrefour, RT-Mart, Metro, Wal-Mart in the name of "local promotion fee" or "special display fee" to seek business opportunities and competitive advantages.	Fine of RMB 100,000 and confiscation of illegal gains in the amount of RMB 1,838,622.23
2019-12-27	Shanghai Xuhui AMR	Viva Healthcare (Shanghai) Trading Co., Ltd.	Gave cash to relevant personnel of certain departments of two hospitals as "department activity fees" to seek business opportunities and competitive advantages	Fine of RMB 600,000

The background features a dynamic, abstract composition of light trails. On the left, numerous thin, parallel lines in shades of red and orange streak across the frame, creating a sense of rapid movement. These lines transition into a more solid, deep blue area on the right, which is also filled with subtle, lighter blue streaks. The overall effect is one of high-tech energy and forward momentum.

EMPLOYMENT ISSUES IN DUE DILIGENCE

Employment & Compliance Red Flags at a Target

- We have a global code of conduct in English which applies to all of our subsidiaries, including those in China.
- On Work Rules, the Employee Handbook in China was translated into Chinese, posted on the website and sent it to all employees by e-mail.
- On Data, We don't have a data collection policy tailored for China. We never asked our employees to sign a data collection consent form.
- On WeChat: Everyone in China uses WeChat, and a strict "No WeChat policy" is impossible.
- On Conflict of Interests, we don't have a conflict of interest policy, and we didn't think one is needed.
- On Training, we require all of our employees to conduct online Code of Conduct training.

Key Issues in Understanding Employment Red Flags

- How are employees employed?
- How are they paid?
- Are all employees enrolled in social insurance and housing fund? Properly?
- Do foreigners have proper immigration documentation?
- Is the target unionized?
- High turnover?
- Migrant workforce?

Key Issues in Understanding Employment Red Flags

Work rules:

- Code of Conduct: Conflict of Interest, Anti-Corruption, Anti-Monopoly, Insider Dealing
- Expense Reimbursement Policies
- Security Systems / Electronic Usage and Information Policy
- Protection of the Company's Confidential Information
- Intellectual Property Rights
- Disciplinary Action Process (what disciplinary action is available and for what basis)

The background features a dynamic, abstract composition of light trails. On the left, numerous thin, parallel lines in shades of red and orange streak across the frame, creating a sense of rapid movement. These lines transition into a more structured, grid-like pattern of blue and white lines on the right side, suggesting a digital or data environment. The overall color palette is dominated by deep blues, bright reds, and crisp whites.

CYBERSECURITY AND DATA PRIVACY ISSUES

Cybersecurity and Data Privacy Issues

- Cyber Security Law (“**CSL**”), effective on June 1, 2017, and its implementing regulations and guidelines.
- Personal Information Security Specification (2020 amendment) - Data controller must obtain “informed consent” before collecting their personal information
- Data Security Management Measures (draft version)
 - Filing Requirement for collection of personal sensitive information or important data
 - Assessment and Approval requirement for cross border transfer of important data
 - Stricter requirements for the formulation of collection and use rules

Legislative Updates - Cross-border Data Transfer



- **Cross-border Data Transfer:** *Measures for Security Assessment for Cross-border Transfer of Personal Information (draft for comments) released in 2019*

Data Localization Requirement

“Personal information” and “important data” collected or generated by **Critical Information Infrastructure Operators (CIIO)** in the PRC must be stored in the PRC.



All network operators, not just CIIOs, are required to conduct a risk assessment, and seek approval from governmental authorities before transferring “personal information” and “important data” outside of China.

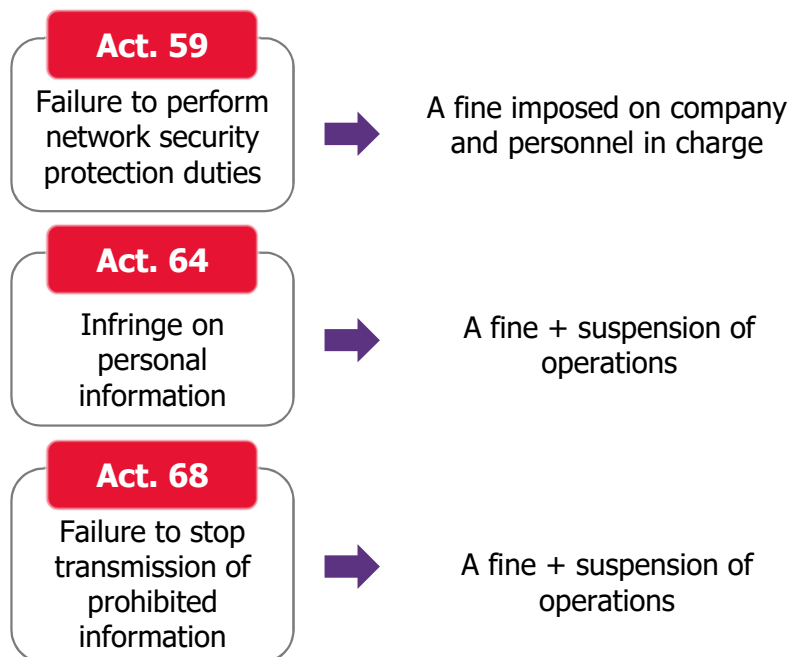


- ✓ Export contract is required between the network operator and foreign recipient – *akin to data transfer agreement/BCR under the GDPR; restrictions on ongoing transfer to third parties*
- ✓ Governmental authorities’ extended administrative power on ongoing monitoring

Cybersecurity and Data Privacy Issues

- Currently the relevant provisions of data localization requirement are in draft versions (except for the critical information infrastructure operator (CIIIO) scenario).
- If the draft law comes into effect, the relevant legal obligations set forth therein, including the administrative security assessment, would become an imminent concern for affected operators, where grace period may not be given.
- Even if the customer data is stored on China server, if oversea entities or employees around the globe can have access to the data, there is potential risk that it may also constitute a data export so as to trigger the security assessment requirements, based on the draft Guidelines for Cross-Border Data Transfer Security Assessment.

Penalties & Enforcement



More frequent inspections: Nearly 600 apps were inspected and 200 apps were required to rectify in 2019.

Increasing crime and administrative penalties: In Beijing police's enforcement actions against internet-related violations: 3,900 cases were detected, 4,700 suspects were arrested, 1.9 million illegal information were cleared, and 780,000 illegal accounts were shut down during the first half of 2019.

Judicial guidance published for data-privacy related lawsuits: The Supreme People's Court released its first batch of internet-related judgements for representative cases, including data-privacy related lawsuits in August, 2018.

Business risks: The IPO application of Weather forecasting app Moji was rejected by CSRC due to its non-compliance of data collection policy.

The most severe penalties for network operators is usually suspension of business or shut down of website.

Data Mapping

- Data-mapping questionnaire helps to get a full picture about how the data moves or flows through the company and identifies major data privacy compliance risks.
- Review of data consent process to meet the consent and notification requirements under PRC data protection laws.
- Data processing agreements (“**DPA**”) with the vendors is required to allocate the duties and responsibilities for data protection.

The background features a dynamic, abstract composition of light trails. On the left, numerous thin, parallel lines in shades of red and orange streak across the frame, creating a sense of rapid movement. These lines transition into a more solid, deep blue area on the right, which is also filled with subtle, lighter blue streaks. The overall effect is one of high-tech energy and forward momentum.

OTHER KEY LEGISLATIVE UPDATES IN CHINA

Legislative Updates – Social Credit System

2014

Planning Outline for the Construction of a Social Credit System (2014-2020)

Key Points

- By 2020, fundamental laws, regulations, and standard systems for social credit shall be basically established
 - credit investigation system
 - credit supervision and management systems
 - credit service market system

2019

Guiding Opinions on Accelerating the Construction of a Social Credit System and Building up a New Credit-Based Regulatory Mechanism

Key Points

- To establish credit records for market players
- To construct a cross-regional, cross-industry, cross-sector joint disciplinary mechanism against dishonest/fraudulent business practices
- To explore the establishment of a credit repair mechanism
- To make full use of the "Internet Plus Regulation System" and big data in credit supervision

Impacts on Business Entities

Black list

- “**Joint sanctions**” – “misconduct somewhere, restrictions everywhere”
 - Subject to restrictions in terms of customs, foreign exchange, finance, government cooperation, government approvals, reputation, etc.
- A serious misconduct by a business may not only affect the company itself, but may also have implications to such company’s **senior management**.

Red list

- **Various incentives** will be offered to the companies covered by a red list.
 - For example, green channels for processing tax matters, priority in customs clearance, and priority when applying for certain permits and licenses.

The background features a dynamic, abstract composition of light trails. On the left, numerous thin, parallel lines in shades of red and orange streak across the frame, creating a sense of motion. These lines transition into a more solid, deep blue area on the right, which is also filled with subtle, lighter blue streaks. The overall effect is one of high-tech energy and digital connectivity.

CHINA'S UNRELIABLE ENTITY LIST

MOFCOM Announcement

- On May 31, 2019, China's Ministry of Commerce ("**MOFCOM**") announced that the Chinese government will soon release an "Unreliable Entity List" ("**UEL**") identifying names of foreign companies and individuals that boycott or cut off supplies to Chinese companies for **noncommercial purposes**.
- MOFCOM stated that it would consider the following factors in totality when deciding whether to add an entity to the list:



1. whether the entity imposes blockades, ceases to supply, or resorts to other discriminatory measures against Chinese entities;
2. whether the entity's actions are taken for noncommercial reasons and violate market rules and the spirit of any contract entered into by that entity;
3. whether the entity's actions materially damage the interests of Chinese entities or related industries; and
4. whether the entity's actions constitute a threat or potential threat to China's national security.

Strategic Considerations



The MOFCOM spokesman remarked that the "Unreliable Entity List" regime, as a system design, is not targeting any particular industry, nor any specific enterprises, organizations, or individuals.

- Conduct an internal review of the company's relationship with Chinese entities and assess risk factors related to compliance with China's Anti-Monopoly Law.
 - *Article 17 prohibits companies from abusing a dominant market position through (i) refusing to conduct transactions; or (ii) imposing discriminatory conditions against another company without legitimate purposes.*
- Prepare for potential affirmative defenses.
 - *Chinese authorities will conduct a prelisting investigation before placing any entity or individual on the UEL and give targets an opportunity to assert affirmative defenses.*
- Train employees on how to respond to government inquiries and investigations conducted with or without notice.
 - *Prepare for the dawn raids for antitrust enforcement.*

Q&A

The background of the slide is an abstract composition of light trails. On the left side, there are numerous horizontal streaks of red and orange light, which appear to be blurred or moving quickly. These streaks transition into a series of parallel lines that curve towards the right side of the frame. The lines are primarily blue and white, with some yellow and orange highlights, suggesting a high-speed or digital theme. The overall effect is one of dynamic movement and energy.

Biography



K. Lesli Ligorner
Partner

Beijing/Shanghai

T +86.10.5876.3688

lesli.ligorner@morganlewis.com

K. Lesli Ligorner serves clients on a wide range of labor and employment matters involving hiring and termination, establishment and enforcement of company policies, the Foreign Corrupt Practices Act (FCPA) and local anticorruption compliance, and discrimination and harassment policies, training, and investigations.

She also advises on global mobility and immigration, employment and anticorruption due diligence in mergers and acquisitions, leaves of absence, wage and hour laws, intellectual property protection, and unionization and collective bargaining.

For three consecutive years, Lesli was listed as one of the “Attorneys Who Matter” in the labor and employment category by the Ethisphere Institute,. She has also been listed in *Chambers Global* and was named “Lawyer of the Year” for Labour & Employment by *China Law & Practice* and *AsiaMoney Women in Business Law*.

Morgan Lewis



Biography



Todd Liao
Partner

Shanghai

T +86.21.8022.8799

Todd.Liao@morganlewis.com

Morgan Lewis

Todd Liao works with clients on a wide range of financial transactions and legal issues involving China. He frequently works with multinational corporations on cross-border mergers and acquisitions, foreign direct investment and investment financing, disposal of Sino-foreign joint ventures and assets, and the structuring of complex commercial transactions. Todd also handles intellectual property (IP) work, specifically assisting clients with managing their trademark portfolios. He is admitted to practice in New York only.

In addition, Todd counsels on matters related to the US Foreign Corrupt Practices Act (FCPA) practice in China and throughout the Asia-Pacific region. He advises multinational corporations regarding compliance with the FCPA and other regulatory compliance matters including policies and practices, gifts, travel and entertainment policies and violations, third-party due diligence issues, managing and conducting investigations of alleged FCPA violations, whistleblower investigations, and employee disciplinary actions. He also conducts FCPA training in multiple languages and regularly presents at industry conferences.

He is fluent in Mandarin Chinese, English, Shanghainese, and Cantonese.

Our Global Reach

Africa

Asia Pacific

Europe

Latin America

Middle East

North America

Our Locations

Abu Dhabi

Almaty

Beijing*

Boston

Brussels

Century City

Chicago

Dallas

Dubai

Frankfurt

Hartford

Hong Kong*

Houston

London

Los Angeles

Miami

Moscow

New York

Nur-Sultan

Orange County

Paris

Philadelphia

Pittsburgh

Princeton

San Francisco

Shanghai*

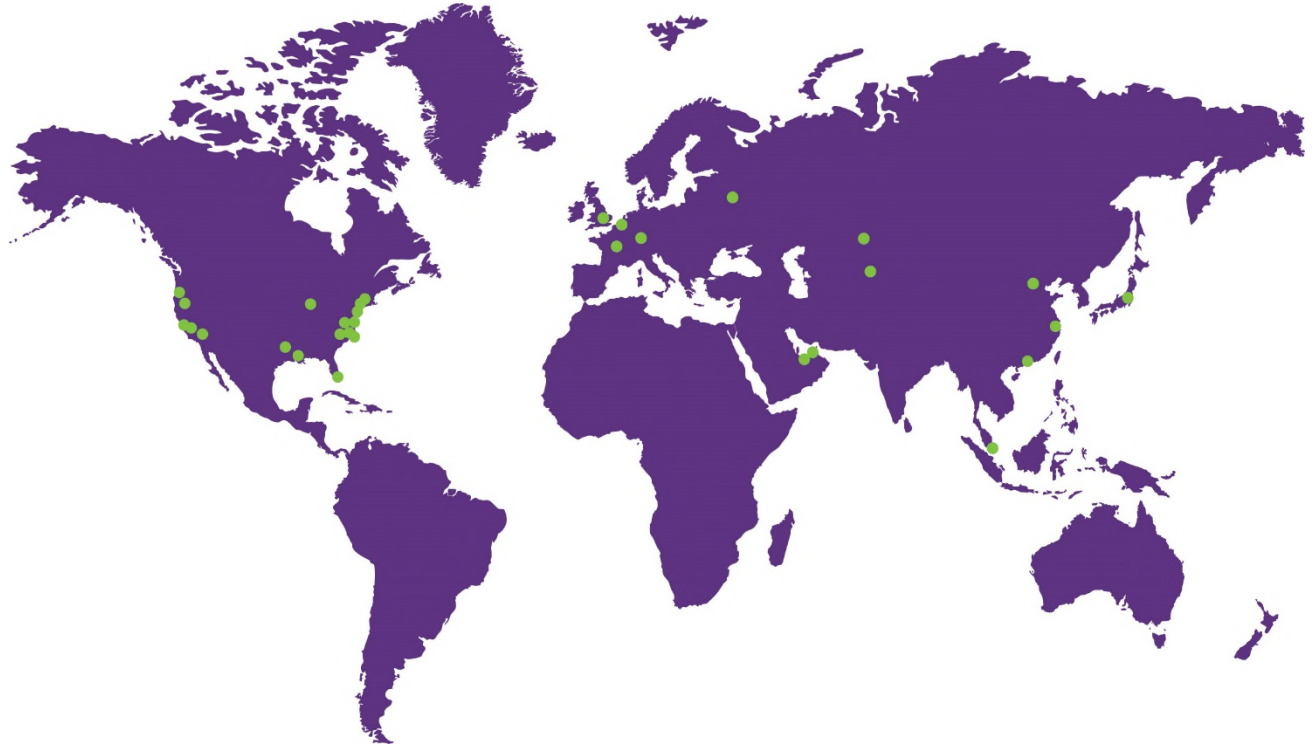
Silicon Valley

Singapore*

Tokyo

Washington, DC

Wilmington



Morgan Lewis

*Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

THANK YOU

© 2020 Morgan, Lewis & Bockius LLP
© 2020 Morgan Lewis Stamford LLC
© 2020 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.

Morgan Lewis