PRACTICE GUIDES

China M&A

Second Edition

Contributing editor
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Sanctions and Trade Compliance Considerations in M&A Transactions in China

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Sanctions and trade compliance regulations in China are constantly evolving and maturing. In years past, China's trade regulatory schemes were primarily focused on revenue protection with a secondary focus on national security concerns. China's approach to sanctions laws is to comply, within reason, with the United Nations (UN) Security Council sanctions passed with international consensus. Nevertheless, as China's economy continues to evolve and move up the value chain, its own domestic demand has necessarily reduced the focus of trade regulations on traditional revenue protection, with average duty rates continuing to fall. Concurrently, with higher value-added technology and product development being the focus of China's industrial policy, national security has necessitated an evolution of its approach to sanctions, which remains a work in progress, as discussed further below.

What this means for parties to M&A transactions in China is that an approach to due diligence and risk assessment must take a wider view of potentially impactful regulations. In addition, a fundamental understanding of China's corporate law and registration requirements will assist in implementing a prudent approach to managing quasi-successor liability concerns in Chinese M&A deals. In certain sectors, specific terms may be useful in addressing some of these unique trade regulatory and sanction concerns in China. This chapter provides an overview of the relevant regulations and provides some insights into how these regulatory schemes can assist in driving due diligence, agreement drafting and post-completion implementation.

Sanctions

China has yet to implement a comprehensive legal framework for the imposition of unilateral sanctions or even for the robust enforcement of internationally imposed sanctions. Currently, sanctions and trade embargoes are generally provided for under the Foreign Trade Law of the People's Republic of China (2016). Under article 16 of the Law, the import and export of certain

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goods or technology may be restricted or prohibited where necessary as provided for under international treaties or agreements to which China is a party. In addition, article 17 of the Law provides that in times of war or for keeping international peace and security, the state may take any necessary measures concerning the import or export of goods or technology.

Therefore, in accordance with the Foreign Trade Law, and as a permanent member of the UN Security Council, China complies with UN sanctions-related resolutions and embargoes. The mechanisms by which China implements such sanctions and embargoes are intergovernmental administrative notices initiated by the Ministry of Foreign Affairs (MFA), which is primarily responsible for the negotiation and maintenance of international agreements under which China may implement sanctions or embargoes. Following notification from the MFA, circulars will generally be issued by relevant enforcement agencies responsible for implementing such sanctions:

- the General Administration of Customs of the People's Republic of China (China Customs);
- the People's Bank of China;
- the China Banking and Insurance Regulatory Commission;
- the China Securities Regulatory Commission;
- the Ministry of Transportation; and
- the Ministry of Public Security.

One such example of an implementing circular involved China sanctioning an entity and individual pursuant to a UN resolution. Accordingly, a circular was issued from the People's Bank of China to halt banking services and freeze assets and bank accounts of the sanctioned parties.[2]

New developments

With the ongoing China–US trade tensions, China has announced the creation of its own individual and entity sanction list (see below). Since 2018, China has made several sanctions-related announcements, included announcing sanctions on 11 US legislators and foreign policy experts and other US individuals in early August 2020 in response to certain US legislation relating to matters that, in China's view, remain internal domestic affairs. In addition, China has similarly announced sanctions against a US defence contractor in response to arms sales to Taiwan in July 2019. Beyond official statements from the MFA, there has been no reference to the specifics of such sanctions or the measures to be taken, nor have there been any government agency circulars issued in furtherance of such sanctions. Nevertheless, this remains a space to watch closely.

Unreliable entity list

Having had several high-profile Chinese entities and their affiliates added to the US entities list, which is administered by the Bureau of Industry and Security of the US Department of Commerce, China's Ministry of Commerce (MOFCOM) announced the creation and imminent release of an unreliable entity list (UEL) in May 2019, which has recently been supplemented by the Provisions of the Unreliable Entities List that took effect on 19 September 2020. The legal basis of the UEL is founded upon China's Foreign Trade Law, the Anti-Monopoly Law, the National

2 Circular of the People's Bank of China on Implementing Relevant Resolutions Made by the United Nations Security Council, No. 187 [2017] of the People's Bank of China.

Security Law and the Foreign Investment Law.[3] The intention of the UEL is to impose a boycott and embargo on foreign enterprises, organisations or individuals that assist a foreign government in cutting-off supplies to Chinese companies for non-commercial purposes, causing serious damage to the interest of Chinese companies or threatening China's national security.

Pursuant to article 7 of the Foreign Trade Law and article 40 of the Foreign Investment Law, the UEL may be interpreted as prohibiting compliance with a foreign government that results in a discriminatory, prohibitive or restrictive measure against China. As a result, a foreign company that complies with its own government's rules may also face market access sanctions in China, such as restrictions on trade or investment, or a denial of requested permits and licences. These quasi-sanction measures from China may apply to named foreign entities as well as their affiliates and subsidiaries in China. It is expected that MOFCOM would also restrict other Chinese entities from transacting business with designated 'unreliable entities'. In addition, foreign individuals such as the officers of named foreign entities may also be included in the UEL, which may lead to the rejection of travel visas, or the restriction or prohibition of activities and employment in China. China has not yet added any companies to the UEL.

While the state will establish a working mechanism for the organisation and implementation of the UEL, there are still gaps to fill with respect to penalties and licensing procedures for the new provisions During the course of an M&A transaction, parties should be cognisant of the potential risk in this area and the uncertainty in acquiring Chinese affiliates and subsidiaries of foreign entities that have been added or may be added to the UEL.

Draft Export Control Law

In addition to the UEL, in June 2020, the Standing Committee of the National People's Congress (NPC), which is China's highest national legislative body, completed its second reading of a new draft Export Control Law (the ECL 2020 Draft), which is discussed below. The ECL 2020 Draft does not specifically indicate whether the UEL will be integrated into the Export Control Law (ECL) or implemented separately.

Trade regulation

Unlike the United States, the European Union and other countries that implement robust dual-use restrictions, China does not have a centralised regulatory scheme that restricts trade in high-tech dual-use products or technologies. Rather, China's relevant provisions in this area appear across several laws and regulations.[4]

Of particular significance is China's existing Dual-Use Export Regulation. This Regulation incorporates an appendix of controlled items, referred to as the catalogue of goods classified as

3 See article 7 of the Foreign Trade Law (2016 revision), article 17 of the Anti-Monopoly Law (2007), article 59 of the National Security Law and article 40 of the Foreign Investment Law (2020).

4 Including the Foreign Trade Law (2016 revision) and the Customs Law (2017); administrative regulations including the Regulations on Arms Export (2002), the Regulations on Control of Nuclear Export (2006) and the Regulations on Control of Nuclear Dual-Use Items and Related Technologies (2007); and the Administrative Measure for the General Licensing for Export of Dual Use Items and Technologies (2009).

'dual-use' in accordance with the 10-digit harmonised system (HS) code[5] used for China Customs purposes. This list is typically updated annually in January. Inclusion in the dual-use catalogue indicates that the items are considered to have both a civilian and military application and, therefore, a licence for export is required. For controlled items that are not in the catalogue, which includes especially sensitive technologies, the Chinese agencies can impose an embargo, prohibit exports to specified destinations, individuals or entities, and apply temporary controls for up to two years.

This Regulation clearly lacks the robust dual-use controls implemented in most major nations in which multinational companies may be accustomed to operating. The HS code merely provides a descriptive statement of an object but does not address its technical characteristics or capabilities, which is what the state is most concerned with when determining whether a dual-use item should be controlled. For example, items can be categorised under the same HS code, but some may possess certain mechanisms that result in these being controlled items while others would not qualify as controlled items. In addition, intangible technologies are nominally controlled but there remains no clear enforcement or administrative system with which to do this. Nevertheless, in an M&A transaction, parties are advised to take note of the products and technologies in which the target entity primarily deals, and whether export licences have been promptly obtained and any conditions thereto have been strictly applied by the target. Punishment under this Regulation can include the loss of foreign trade privileges under Chinese law.

Draft Export Control Law

As discussed above, the NPC Standing Committee completed its second reading of the ECL 2020 Draft on 28 June 2020. In 2017, MOFCOM released the first draft of the ECL (the ECL 2017 Draft) for public comment, which was followed by the revised draft in December 2019 (the ECL 2019 Draft). Once passed and implemented, the ECL 2020 Draft will mark the first comprehensive and unified export control regime in China and will create clear legal authority and investigative power for the enforcement of China's export controls.

The ECL 2020 Draft sets forth four categories of 'controlled items':

- dual-use items;
- military items;
- nuclear items; and
- other goods related to technologies, services and items pertaining to national security.

Exporters would need to apply for licences to export items on the control lists from China. Parties in the course of M&A transactions are advised to determine whether the target is involved in the production, sale or export of controlled items, which runs the risk of liability or penalty for violation of the ECL.

Article 12 of the ECL 2020 Draft requires licences for the export of controlled items included in the control lists and items subject to temporary control. Notably, a newly added article 44 to the ECL 2020 Draft emphasises the 'extraterritorial application' of the ECL, which would hold

5 The latest classification is provided in the 2020 edition of the *Dual-Use Goods Catalogue* (MOFCOM/GAC Announcement 2019/68).

organisations and individuals outside China liable for: violations of the ECL; hindering the performance of non-proliferation and other international obligations; or endangering China's national security.

The latest draft also strengthens the enforcement and penalty provisions under the ECL. In the provisions of article 28 of the ECL 2017 Draft, which were removed from the ECL 2019 Draft but added back to the ECL 2020 Draft, the competent authorities held significant investigative authority to carry out the following if an exporter was suspected of violating the ECL:

- conduct on-site inspections;
- interview investigated persons, interested parties or other related organisations or individuals;
- access and copy relevant documents;
- inspect shipments;
- seize assets; and
- examine bank accounts.

If the Law is enacted as drafted, the emphasis on licence requirements, extraterritorial application and strengthened supervision of dual-use items and end users will broadly empower the competent authorities to investigate entities beyond the normal territorial boundaries of China and inspect dual-use products and the end users of controlled items.

An acquirer would have to consider the potential for successor liability if the target entity violated the ECL, including the possibility that such violation occurred outside the territory of China. Apart from the potential compliance obligations of the target entity as an exporter or end user, if the target entity is a service provider additional caution is required in engaging exporting activities. The newly added article 20 in the ECL 2020 Draft prohibits any service provider from providing shipping, delivery, customs clearance, third-party e-commerce trading platforms or financial services for any export operators facilitating the export of any controlled items that violate the ECL. Thus, even if the target is not a direct exporter or end user, any party to the supply chain must ensure its activities are in compliance with the ECL.

Violations of the ECL could result in penalties of up to 10 times illegal business revenue resulting from transactions conducted in violation of the ECL, in addition to the confiscation of any illegal income. In the course of an M&A transaction, parties should also be aware of non-financial penalties that may also be imposed on businesses, including the suspension or revocation of export licences and being blacklisted in China's social credit system.

Both the 2019 and 2020 drafts also emphasise the importance of establishing internal audit systems for export control compliance. Under article 14 of the ECL 2020 Draft, the competent authority has the discretion to grant licensing facilitation measures, such as general licences to expedite the licensing process where the internal compliance measures are deemed to be sufficient. Particular attention may be warranted for ECL compliance, internal compliance programmes and the possibility for general licences.

It took two years for the NPC to release the first review of the ECL in December 2019; however, the prompt second review that followed in June 2020 shows that the NPC is on track and determined to promulgate the Law in late 2020 or early 2021. The NPC is expected to issue a new and consolidated export control catalogue after promulgating the ECL; items such as indigenous sensitive and cutting-edge technologies in response to the latest export control measures from the US government, and strategic resources such as rare earth metals, are expected to be included in the catalogue. With the imminent promulgation of the ECL, parties are well advised to be mindful of the legislation's progress and understand the implication of the draft ECL in regard to compliance obligations, target business operations and supply chain in the impending M&A transaction. They should also establish internal export control compliance mechanisms in the newly acquired entity.

Import and export of technologies

On 28 August 2020, Announcement No. 38 was jointly issued by MOFCOM and the Ministry of Science and Technology, revising the Catalogue of Technologies Prohibited and Restricted from Export by China (Catalogue) pursuant to the Regulations on the Administration of the Import and Export of Technologies (Order 709).[6] These Regulations, which were initially promulgated in 2001 and amended in 2008, have become a greater focus of the central government as China has developed higher value home-grown intellectual property. The recent amendment to the Catalogue is the first in more than 10 years, with the previous Catalogue having been issued in 2008.

Order 709 imposes control over the transfer of technology from within China to outside China, whether by trade, investment or economic and technical cooperation. The Regulation purports to control all transfers of technology regardless of the type of technology or whether the technology is permitted, restricted or strictly prohibited. For permitted technology exports, a simple recordal process is required, which is made with the local bureau of commerce under MOFCOM with jurisdiction over the location where the requesting entity is established. Restricted exports are subject to a licence requirement, which are also applied for and obtained from the same commercial bureau.

There are 17 industrial sectors impacted by China's amended Catalogue. Some of the more significant technologies in terms of strategic and commercial relevance include, but are by no means limited to, the following:

- pharmaceutical and biotechnology manufacturing, including technologies required for the development of vaccines;
- technology relating to the development, testing and maintenance of machine tools;
- 'strategic' new product design technology for heavy machinery;
- unmanned aerial vehicle technology;
- speech synthesis technology;
- artificial intelligence interaction and interface technology;
- voice evaluation technology;
- personalised push notification technology based on data analysis techniques;
- cryptographic chip design and implementation technology; and
- quantum encryption technology.

Technology developed in China, regardless of its origin or the shareholding identity of the licence applicant (ie, foreign-invested enterprises), will be subject to these controls. As there is no distinction regarding the origin of the technology, it remains possible that foreign technology utilised by a Chinese entity outside China could well be subject to licence requirements.

6 Order 709 of 18 March 2019.

Moreover, multinationals that utilise R&D centres in China may also be impacted by restrictions regardless of the domicile of the parent or the arrangements under which the technology was developed in China. While this may not have been a significant issue previously, the amendments to the Catalogue will undoubtedly now impact many multinationals.

In accordance with Chapter IV of Order 709, any persons or organisations found in violation of its requirements may be punished. These measures include confiscation of illegal income gained through violation of the technology licence restrictions or prohibitions and even criminal prosecution under state secrecy laws. However, it is unclear how such enforcement will occur.

Beyond MOFCOM and local commercial bureaux, the international banks in China may also play a role. Under China's existing foreign exchange regulatory scheme, banks are tasked with verifying the legitimate commercial agreements and transactions under which foreign currency may be received by an account holder. In this capacity, the banks may well verify that a technology licence agreement has been registered with the commercial bureau and, where applicable, an export licence has been obtained, prior to approving the receipt of foreign currency. Finally, China's General Administration of Customs (GAC) will continue to play its traditional role in export to the extent the technology export consists of tangible goods. Otherwise, where technology is contributed as a capital contribution for the establishment of a new foreign subsidiary for which licence fees have not been received, the supervision and enforcement of Order 709, as well as the basic compliance with the restrictions, may well prove challenging for all involved.

Parties to the M&A transactions are advised to refer to the ECL to formalise a method by which technologies may be classified so as to determine their regulatory treatment, and provide a clearer insight into the enforcement and supervision of such controls, as well as more robust administrative procedures for compliance. In the meantime, the uncertainties created under this Regulation may well further cool cross-border transactions and cooperation, including foreign investment, involving China.

Enterprise credit management system

In the 1980s, the GAC introduced a classification system for enterprises carrying out import and export businesses in China based on the compliance records of trading entities. This system has subsequently undergone significant changes pursuant to GAC Order No. 225 in 2014[7] and Order No. 237 in 2018.[8]

Order No. 237 classifies enterprises into certified enterprises, general credit enterprises and dishonest enterprises according to their credit standing.[9] Certified enterprises are authorised economic operators that may receive preferential treatment such as fewer inspections and simplified customs processing. On the other hand, trading enterprises with a poor credit rating may be subject to much tighter surveillance that could impede normal business operations. The GAC makes these credit ratings and violation records of non-compliant enterprises available on the Credit Publicity Platform of Import and Export Business of Customs. As such, a buyer should check the target company's status and assess its post-merger position.

7 Interim Measures on Enterprise Creditability.

8 Measures of the General Administration of Customs of the People's Republic of China for Enterprise Credit Management, effective on 1 May 2018.

9 Article 3 of Order No. 237.

Following up on a division or merger of an enterprise, the GAC may adjust the credit standing in different circumstances. In accordance with article 21 of Order No. 237, where a surviving company holds subsisting major rights and obligations of the enterprise after split or spin-off, the credit rating shall remain the same, whereas the newly formed company shall be regarded as having a general credit rating because of its initial registration. In the case of a merger, the credit rating of the surviving entity shall apply to the newly combined enterprise. However, where two companies merge into an entirely new corporate entity, the new entity shall be regarded as such and be assigned a general credit rating regardless of the status of the legacy entities.

An acquirer may review the target company's credit information on the GAC website, which includes information on the enterprise's registration, its credit standing, any applicable administrative licensing or punishment imposed by the GAC, and implementation of joint incentives or joint punitive actions.[10]

Thorough consideration should be taken when acquiring a dishonest enterprise because it may take two consecutive years of solid compliance for the GAC to reassess its status as a general credit enterprise.[11] Specifically, to recover the credit rating of an entity, there must be no smuggling offences, a strict limit on violations of customs supervision provisions within a one-year period (not exceeding 1 per cent of the total number of customs declaration forms), import and export recordation lists, a maximum of 1 million yuan in accumulative administrative fines imposed by the GAC and prompt payment of taxes and fines. Finally, the business premises shall be made available for on-site investigation, during which accurate and complete information must be supplied to the GAC and full cooperation with customs officers in the legal performance of their duties must be provided.[12]

As discussed below in the context of China's quasi-successor liability concept, an entity with a poor enterprise credit rating with the GAC will, during its time as a dishonest enterprise, experience an inspection rate of 80 per cent above the average rate for imported and exported goods. There is no exemption from inspecting fees or expenses for lifting, moving or warehousing. Such entities may not participate in the consolidated tax collection system, and a guarantee is required to be paid in full if a duty-deferred manufacturing or processing facility is operated. The frequency of enterprise verification and inspection will also be increased. Punishments of enterprises acting in bad faith will be imposed by the relevant state department in addition to other administrative measures prescribed by the GAC.[13]

These measures may not only cause damage to a company's reputation but may also affect its normal business operations. Therefore, a strong compliance system should be put in place to ensure compliance with China Customs. If necessary, an acquirer may consider actively

10 id., at article 9.

11 id., at article 13.

12 id., at article 12.

13 id., at article 25.

disclosing its violating behaviour on its own initiative and receive a warning or a GAC fine of 500,000 yuan; the act shall not then be considered in the credit standing of the company.[14]

Successor liability

In China, a proposed merger or acquisition transaction often neglects appropriate consideration for due diligence in trade compliance. It is particularly challenging to deal with trade matters in China because of the lack of clear rules and precedents. By carrying out trade due diligence, the acquirer is able to include risks in the valuation of the purchase price, incorporate specific provisions, or, in the extreme, abort the proposed transaction.

While China has no specific precedent that incorporates a clear concept of successor liabilities, it remains a significant consideration, as with other jurisdictions, that the seller's liabilities may transfer to the acquirer under certain circumstances. Traditionally, an asset-only transaction in which a buyer is merely acquiring the seller's assets is possible, to limit the buyer's responsibility for the seller's legacy liabilities. Conversely, a traditional share purchase agreement often involves the assumption of legacy liabilities by the buyer. Although such risks may be mitigated to some extent by sellers' warranties and indemnities insurance prior to execution of the agreement, this may not be ideal as it is subject to limitations and may present challenges for enforcement in China. As such, due diligence for trade-related compliance should be considered an important addition to the standard legal due diligence process.

The concept of successor liability in China can be found by reference to several regulatory provisions. For example, under article 24 of the Regulations on the Merger and Division of Foreign-invested Enterprises (2015 revision), companies undergoing a merger shall assume all creditors' rights and debts of the companies dissolved as a result of the merger. This principle can also be found under article 174 of the Company Law of the People's Republic of China (2018 revision). In addition, article 287 of the Interpretations of the Supreme People's Court on the Application of the Criminal Procedure Law of the People's Republic of China states that, where the company as defendant undergoes a merger or split during a criminal trial, the fine imposed on the defendant shall carry forward to the successor entity to the extent of the property and financial interests that the defendant unit contributed to the new entity and the same applies to the person in charge for the original company.

A company is required to submit a merger agreement signed by all parties involved in the merger, which contains the succession plans for the claims and liabilities of the parties to the merger agreement when applying for incorporation, change or cancellation registration due to merger.[15] As such, the debts and liabilities, including public debts, must be adequately addressed in the transaction agreements.

14 See Paragraph IX of the Announcement on Relevant Matters concerning the Implementation of the Measures of the Customs of the People's Republic of China for the Administration of Enterprise Credit (Announcement No. 178 (2018)).

15 See article 20 of the 2015 Regulations and the Specifications on Materials Submitted for Registration of Domestically funded Enterprises by the General Administration for Industry and Commerce (Gong Shang Qi Zi [2014] No. 29).

Appendix 1

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William Marshall is a partner at Tiang & Partners, which is an independent Hong Kong law firm associated with PwC Legal International Pte Ltd (a licensed foreign law practice) in Singapore. He is highly regarded by clients for his practical, commercially savvy legal and strategic advice. An international trade and supply chain lawyer and adviser with more than 20 years of experience in large international firms and senior-level in-house counsel positions at listed companies, William has extensive experience acting for multinational clients in trade regulatory matters such as Chinese customs audits and investigations, trade remedy actions and post-merger integration of supply chain operations, as well as supply chain restructuring projects for duty and tax efficiency.

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