Chinese companies looking to invest in the UK can choose to set up their own company, but may prefer to take over an existing business through a merger or acquisition. This allows the Chinese company to take advantage of the experience and reputation of the UK target company.

Investors should take care during the due diligence process and be aware of how the UK's common law system impacts on corporate transactions, but purchasing a UK company with easy access to the European and US markets can offer significant advantages to Chinese investors.

Here, our corporate experts set out an overview of the main issues facing Chinese companies looking to acquire or merge with UK companies.

### Acquisitions in a common law system

In contrast to civil law jurisdictions the common law places greater importance on judicial decisions and applies the doctrine of precedent, which aims to decide similar cases based on previous decisions of higher courts. Operating alongside this system in the UK is a series of conventions and principles which have stood the test of time and remain part of the legal system to this day. One of the most significant of these is the principle of 'Caveat emptor', which translates from Latin as "let the buyer beware". It is central to UK law on commercial contracts, including mergers and acquisitions.
When buying a company or business in the UK there is very limited statutory protection for the buyer on the nature or extent of the assets and liabilities being acquired. The buyer is responsible for learning about the assets and liabilities it is acquiring. This means that even a small company can have potentially unlimited liabilities that would remain with the company and transfer to the buyer (on a share purchase).

'Caveat Emptor' does not mean that a seller can deliberately conceal liabilities or misrepresent the state of the company. In these circumstances a buyer that has been induced by the misrepresentation to buy the business can take action against the seller for misrepresentation.

However, the seller will not be at fault in cases where they have failed to mention a problem about which they have not been asked, made an innocent mistake or have no knowledge of a particular issue. The Chinese buyer must therefore ensure it is fully protected in the sale and purchase contract and undertake a rigorous due diligence process (see "Due Diligence" below).

**Asset or share purchase?**

One of the first decisions the Chinese investor will have to make once the target company has been selected is whether to pursue an asset or a share purchase. A share purchase involves taking over the target company along with all of its assets, liabilities and obligations. An asset purchase will only see the assets and liabilities specified in the sale and purchase agreement transfer to the buyer (although see below regarding employees).

The choice of either an asset or a share purchase will depend on the target and the plans that the Chinese investor has for the future direction of the business. Share purchases can usually be completed by a simple stock transfer form, whereas the formalities for an asset purchase will depend on each individual asset. For example, real estate will need to be conveyed and registered, the relevant assignments will need to take place for intellectual property (IP) to transfer to the buyer etc. In both cases, a comprehensive underlying purchase contract will have to be negotiated (see "The Sale and Purchase Agreement" below).

A share purchase will generally see the business transferred as a "going concern" and most contracts (subject to change of control provisions) with employees, suppliers and customers will remain with the target company under its new owners. With asset purchases those contracts will not automatically transfer, although Chinese investors should bear in mind that under UK employment law some employee liabilities may transfer to the buyer (see this alert from our employment team for more detail).

The buyer should consider the scope of any potentially hidden liabilities, the tax implications, and the requirements for third party consents or shareholder approval before deciding which model
to use. Often, sellers will prefer a share purchase, but if the buyer is not willing to take on this level of risk one option may be to "hive down" the assets into a new company and purchase the shares of that company.

**Due diligence**

The due diligence (DD) exercise is generally split into three areas: commercial, financial and legal.

Commercial DD is normally carried out by employees of the buyer and involves the sharing of information about broad issues surrounding the target company's operations. It should cover the state of the market the company operates in, its strengths and weaknesses, sales and marketing and major competition. The discoveries made during commercial DD will help direct the financial and legal DD and flush out serious issues at an early stage.

Financial DD is carried out by accountants and will focus on those areas of the target's financial affairs that are most relevant to the buyer's decision to purchase. This process will often help reveal the best acquisition and financing structure.

Legal DD is the most in depth part of the process. It is tailored to each company and will normally focus on those areas identified through commercial DD. The areas perceived to carry the most risk to the buyer will be subject to the greatest scrutiny, including investigating title to important real estate, reviewing significant commercial contracts, reviewing employment contracts and pensions arrangements, and establishing the status of important IP rights.

Other issues such as environmental pollution, reputational issues, tax issues and ongoing litigation etc should be investigated during legal due diligence. The process usually involves a wide-ranging questionnaire being sent to the seller by the buyer's solicitors. The seller will usually share key documents with the buyer, often via a virtual data room. This involves uploading the documents to a secure website where they can be examined and is particularly useful for international deals.

The key risk for many buyers is that the target company may be involved in lengthy and expensive litigation. For example, a company that is in the process of being sued by a former employee for unfair dismissal may have to pay very substantial compensation. A company facing legal action for breach of environmental regulations or a government clean up order could face a hefty bill in the near future.

If these issues are not revealed by DD and come to light after a share purchase is complete, the target company may face significant liabilities. The buyer will have to bear these liabilities,
unless they are protected through a carefully drafted set of warranties and indemnities in the sale and purchase agreement.

**The sale and purchase agreement**

There is significant freedom of contract in UK acquisitions. Unlike in China, a common law court will not retrospectively alter the purchase price for a company on the basis of fairness. It is up to the buyer to ensure it has the necessary contractual protection included in the sale agreement if a post completion problem occurs within the business.

The DD exercise will usually reveal areas of risk for the buyer and unless they are so severe as to force the deal to collapse, the buyer will need to protect their position in the contract. The seller will usually provide extensive warranties (promises that various aspects of the target company are free of risk) in response to reasonable requests from the buyer. The warranties given tend to be qualified by disclosures (statements made by the seller where the state of the target is such that it may breach a warranty).

To avoid liability under a warranty the seller will disclose all relevant facts to the buyer. The parties are then free to negotiate further contractual protection or potentially renegotiate the purchase price. This system of providing warranties and then effectively contradicting them with disclosures has the effect of forcing the seller to reveal information that it may not have been possible to discover during the DD process or that was being concealed by the seller until later in the deal. Some agreements fall apart at this stage, but it is a crucial step in protecting the Chinese investor against hidden liabilities.

Where a warranty is breached following the execution of the sale agreement the only remedy available to the buyer is damages. The damages award is assessed by the courts in relation to the value of the target. The buyer can expect to recover the difference between the value of the company had the breach not occurred and the actual value. Chinese investors wishing to avoid expensive and time consuming litigation can insert arbitration or mediation clauses into the sale and purchase agreement to provide for the possibility of future disputes.

Clearly where a company has a potentially unlimited liability damages may exceed the share price of the company and a claim for breach of warranty would not provide sufficient compensation. Where specific liabilities are identified either during DD or through a disclosure by the seller the buyer will often negotiate specific protection in the form of an indemnity. This would allow the buyer to recover the whole cost of a specific liability. If an indemnity cannot be secured, a reduction in the purchase price might be the only option to save the deal.

An alternative can be to defer part of the price, (sometimes with the deferred part of the price
held in a separate protected bank account) or to make part of the price contingent on future events (known as an "earn-out"). The total amount paid will then vary depending on whether or not the relevant liabilities are ever incurred.

International considerations

The transaction may attract competition law issues if the merger or acquisition is sufficiently large or the new entity would have a monopoly over a particular market. In the UK, a merger or takeover of a business with a turnover in excess of £70 million may require the approval of the government’s Office of Fair Trading.

If the turnover of the new business also meets the minimum requirement under the European Union Merger Regulation, then the transaction may also require the approval of the European Commission before it can be completed. Specialist legal advice on these issues should be sought at an early stage to avoid any delays to the deal.

Conclusion

Chinese investors should take a cautious approach to a UK acquisition and must carry out extensive due diligence even if a close relationship with the seller has already been established. In a common law jurisdiction like the UK the smallest company, even if it has very few assets, can still have significant liabilities so a carefully drafted contract is crucial. The positive side of the common law system is that it allows considerable freedom of contract, and the Chinese investor can tailor an agreement to make sure the merger or acquisition is the right deal at the right price.