

I N S I D E T H E M I N D S

Corporate Law Client Strategies in Asia

*Leading Lawyers on Successfully Conducting
Business in Asian Markets and Learning the Laws
of Local Jurisdictions*



ASPATORE

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Trends and Challenges for Companies Doing Business in Asia

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Introduction

Multinational companies, investment funds and other businesses are initiating or expanding their presence in Asia, based on the considerable opportunities the region offers. At the same time, Asia poses significant challenges that businesses must address to grow and succeed there.

Lawyers advising companies doing business in Asia must make clients aware of the potential risks to their business strategies and structures, and suggest ways to eliminate or minimize such risks. With this in mind, this chapter utilizes a traditional SWOT framework (i.e., Strengths, Weaknesses, Opportunities, and Threats) to analyze the current environment, and then highlights issues that should most affect the work of lawyers in Asia over the next few years.

Weighing the Pros and Cons

Strengths: Demographics and Economics

A number of demographic and economic trends are particularly attractive for doing business in Asia. Key demographic factors include:

Growing middle class. One of Asia's obvious strengths to any business looking to start or expand there is its large and growing population, particularly its swelling middle class in countries such as China, India, and Indonesia.

This presents interesting opportunities for private equity (PE) funds making early stage and growth investments. While many PE funds from the United States and Europe are seeing fewer options in their home regions, the rise of the middle class has made Asia an attractive high-growth PE investment platform.

Accelerating urbanization. The accelerating urbanization in many Asian countries creates huge demand for the products and services required to sustain middle-class expansion, from housing to education to food. In

China alone, 300 million people are expected to move into cities between 2010 and 2025.¹

Key economic factors include:

- Rising disposable income. Consumption and spending are slowly increasing in many Asian countries, using money that had historically gone into savings. The fact that people have more money to spend (partially because wages are rising)—and are spending a larger percentage of it—is clearly beneficial to businesses that want to sell a product or service in the Asian market.
- Government stimulus. Higher spending is not limited to the private sector. In recent years, the larger and more developed countries have announced stimulus packages to the tune of tens and hundreds of billions of dollars.
- Cheap labor. Although wages are rising in urban areas, Asia continues to have relatively cheap labor available in many countries, notably India, Indonesia, and Myanmar. This trend presents opportunities for outsourcing manufacturing and even services such as document review or analysis of medical results.

Weaknesses

Lack of Infrastructure. From a business's point of view, Asia's weaknesses can largely be defined as lack of infrastructure: legal, financial, physical, and human. Cultural differences can present challenges as well.

Legal. Historically, laws akin to those seen in western jurisdictions did not exist, were immature or rarely were enforced. As a result, neither the affected companies nor the government officials responsible for enforcing the laws knew how to address many issues. This type of vacuum can lead to uncertainty and raise costs—in terms of time and

¹ *China's Urban Billion: New Book Reveals Worrying Future*, ECHINACRITICS.COM (Feb. 27, 2013), <http://www.echinacities.com/china-media/Chinas-Urban-Billion-New-Book-Reveals-Worrying-Future> (last visited July 18, 2014).

money—for companies wishing to establish a business or plan their legal structure.

Such reality directly affects the structure of transactions and operations. For example, some Asian transactions are structured as “offshore” from the country where the actual assets are located, due partly to the inability to create or enforce security rights over some asset categories or the lack of clarity regarding enforcement of basic shareholder rights such as buy-sell or preemptive rights provisions. Difficulties or long time frames in enforcing securities or guarantees make them potentially ineffectual and often require, at the very least, alternative creative security mechanisms to protect investors or lenders.

As is often the case in developing countries, it is common for Asian nations to have a large body of regulation that seeks to limit or control commerce with other countries. Tariffs, currency controls, restrictions on foreign ownership and similar measures can make a foreign party’s attempt to establish a base in Asia a much more complicated process than would be expected in more developed countries. Combined with the legal opacity and corruption common in some developing nations, this can easily frustrate foreign companies doing business in the region.

Financial. Many countries do not have a developed financial infrastructure, which makes certain “traditional” modes of financing impossible.

Physical. Lack of physical infrastructure, such as roads or modern modes of transportation, makes product distribution difficult and hinders potential consumers from accessing products/services being developed.

Human. Human infrastructure is also an issue. Some industries are growing at such a pace that it is virtually impossible to hire and train enough skilled workers to satisfy their needs.

Language and cultural differences. Perhaps more than in other areas of the world, a foreign company seeking to establish, develop, and grow a business in Asia will be faced with language and cultural barriers. An extreme

example we encountered recently was the inability of a local bank in a small Chinese city to process the ampersand sign (“&”) in a company’s name. While this may appear insignificant, it took almost two weeks to navigate the bureaucracy involved, delaying the company’s ability to meet timetables for commencing operations and resulting in business disruption and aggravation for the company.

A common cultural difference appears in private equity deals in China, where a company’s founder often is sensitive to a PE investor’s requirement that the investor nominate the chairman of the board. (Note that such a right comes with little real value if the founder’s right to veto on crucial matters regarding the company has already been built into the purchase agreement.) The founder may therefore respond by being overly aggressive in negotiations if the investor insists upon such a requirement.

A Double-Edged Sword

Opportunities

Even with its challenges, Asia presents great business opportunities:

Quick exits. While less so a decade ago, the existence of limited competition in specific industries or locations, paired with the makeup of and changes in the population, can generate significant growth in time frames that are much shorter than those in more developed regions. Investors can thus earn attractive returns and exit relatively quickly.

Increasing domestic demand. The ability to exploit discrepancies among the cost of capital, cost of labor, and levels of consumption can be very rewarding for companies. Historically, the combination of cheap labor costs with robust Western consumption allowed companies to reduce production costs by shifting production to Asia and increase their margins. Today, Western companies are taking advantage of the strong demand for branded merchandise and services by the increasingly affluent Asian consumer. Asia’s tremendous growth is creating new

demand for certain services and products. A prime example is in the health care industry as the aging population and increased spending power creates an opportunity that previously did not exist.

First-mover advantage. Asia also provides a greater opportunity to be first to market, since markets are in relatively early stages of development in many industries and locations.

More potential acquisition targets. Many successful companies in emerging Asian economies were founded by people who currently are approaching retirement. If their children are not necessarily interested in inheriting or operating the businesses, the door is open for strategic and PE investors to acquire, or invest in, these companies.

Low infrastructure costs. Asian companies frequently are unburdened by the costs of their initial infrastructure, which is often provided free or very cheaply by the government. Profitability and cash flow can benefit accordingly.

Threats

Government intervention. Perhaps the most significant threat to developing a successful business in Asia is that of government intervention and influence. This is more common and prevalent than in the United States or Europe, whether in the form of economic intervention (e.g., currency controls, additional taxes) or legal control (e.g., enacting or enforcing new regulations or policies).

An excellent example is that of Macau, where the success of the hotel and casino business is directly influenced by China's immigration policy. By increasing or limiting the number and extent of the visas given to mainland tourists, the Chinese government can completely change the industry's dynamics. Other recent examples include the measures—primarily additional taxes—adopted by various Asian countries to stem the increase in housing prices.

Shifting legal sands. In many Asian countries, laws and regulations can frequently change and often are dependent on the officials administering

them. Companies face problematic adjustments if such a change requires adherence to a very different set of customs or policies, even if the official law has not changed.

Rising labor costs. Another growing threat is the rising cost of labor in some economies. When an economy such as China, where it used to be inexpensive to manufacture goods, becomes wealthier, there is a push to increase wages. If this push is successful, companies could be compelled to relocate their factories to other places.

The Road Ahead

What follows is a discussion of trends and issues to which companies doing business in Asia will need to pay special attention over the next few years. All of these are derived from one or more of the characteristics described in the preceding SWOT analysis, particularly from those identified under weaknesses and threats.

Increased Regulatory Regimes

Asia has experienced a significant increase in, and tightening of, regulatory regimes. While laws vary from one country to another, many of them do one of the following:

1. Increase reporting requirements, whether for existing regulatory regimes or by adding reporting requirements for industries or activities not previously regulated.²
2. Expand licensing regimes. Many countries have expanded or created new licensing regimes that affect various industries in the region. PE funds expanding into Asia, for instance, will likely have to address such changes in almost every country where they intend to set up.
3. Toughen existing licensing regimes or, in some cases, enforce them for the first time. A good recent example is that of the Hong Kong Securities and Futures Commission, which for the first time

² *New Short Position Reporting Regime in Hong Kong*, PROSKAUER (Feb. 21, 2012), <http://www.proskauer.com/publications/client-alert/new-short-position-reporting-regime-in-hong-kong/>.

determined that the sale of real estate rights amounted to a collective investment scheme.³

4. Impose more aggressive regulatory sanctions.⁴

Anti-Corruption Laws

Private equity firms must comply not only with each Asian nation's anti-bribery and corruption laws, but also with those of their home countries. The United States Foreign Corrupt Practices Act (FCPA)⁵ is a stringent anti-corruption law that adds time, costs, and resources to the conducting of business by US companies and other companies subject to it.⁶

For example, if a business wants to acquire a company, it must conduct thorough FCPA due diligence on the company to determine whether the company has obtained all of its projects, licenses, and permits from the government in a legitimate way, and whether any corruption was involved. In addition, the acquiror must make sure to obtain a series of representations and warranties and add-on indemnifications from the founders or the seller to protect itself against any FCPA-related risks. The acquiror must also consider what type of internal compliance and risk management policy to implement following the company's acquisition, so as to ensure that the company will be FCPA compliant going forward.

It is critical that there be close coordination between the businessperson on the ground and the compliance officer or general counsel, who often sits overseas. In an acquisition context, it is not uncommon for a businessperson who wants to close the deal as soon as possible to

³ *Hong Kong - Applying Securities Laws to Sales of Hotel Units*, PROSKAUER (May 18, 2013), <http://www.proskauer.com/publications/client-alert/hong-kong-applying-securities-laws-to-sales-of-hotel-units/>.

⁴ *Hong Kong SFC Continues to Step Up its Enforcement Action Amidst Enhanced Regulation of IPO Sponsors*, PROSKAUER (Sept. 17, 2013), <http://www.proskauer.com/publications/client-alert/hong-kong-sfc-continues-to-step-up-its-enforcement-action-amidst-enhanced-regulation-of-ipo-sponsors/>.

⁵ Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494.

⁶ *Private Fund Managers Be Aware: FCPA Enforcement is Coming Your Way*, PROSKAUER (Feb. 13, 2014), <http://www.proskauer.com/publications/client-alert/private-fund-managers-be-aware-fcpa-enforcement-is-coming-your-way/>.

advance the deal despite any FCPA-related risks identified. The compliance officer therefore needs to strike the right balance between (a) highlighting any FCPA-related risks and proposing effective measures to address such risks, and (b) meeting the business team's expectations regarding timing, process, and the next steps required to close the deal.

Enforcement and Leverage Issues: Being "Street Smart"

Companies doing business in Asia must recognize that the region is composed of different countries with different legal systems, not all of which have the same enforcement mechanisms as in some Western countries.

Asia is much more relationship-driven than the West, with less reliance on written agreements. Whereas in a country such as the United States, a company with an ironclad agreement may feel safe, in Asia companies should not only have a good agreement, but also adapt to the system and create some business leverage. From a legal perspective, this means being practical and spending more time planning the business structure and how to conduct the business.

Being pragmatic in a big, powerful country such as China—where it is hard to enforce a judgment—is essential. Many deals are structured offshore, and while the business may get security over the shares of an offshore company that ultimately holds the shares of a Chinese company, it does not necessarily have anything secure onshore. Even if the company has a corporate guarantee against the Chinese national or company, failure to register that guarantee with China's State Administration of Foreign Exchange (which is now practically impossible) renders the guarantee unenforceable against the Chinese national or companies to a certain extent.

The uncertainties surrounding Chinese law make it important to draft contracts so that they are governed by Hong Kong, New York or Singapore law. Even so, companies may encounter difficulty when it comes to enforcement of court verdicts, because these may not be respected in China

and may require a new trial on the merits. China is a member of the New York Convention, meaning that it will enforce a valid arbitration award without reviewing the award on its merits. Having said that, enforcement may still take a long time, during which the potential assets may be disposed of or otherwise disappear.

This means that even if one structures an investment to acquire shares of an offshore entity, drafts the documents so they are governed by Hong Kong law, has the seller make warranties and ensures everything is in good order, in the event of a breach—even if one wins a judgment offshore—it is nearly impossible to enforce and try to foreclose the onshore asset.

There are strategies to mitigate these risks. One is to provide for milestone payments, so that the buyer retains some of the funds until it knows that it got what it paid for. In the PE context, buyers can invest in convertible or preferred debt or equity, which provide a mechanism for the investor to adjust the conversion price upon default (which may include failure to achieve an agreed-upon profit target). If default occurs, based on a quantifiable amount of damages, the buyer can adjust the conversion price to immediately get more equity at an offshore level. This is much easier than obtaining and enforcing a cash reward, especially given the variety of mechanisms available to make this happen (e.g., putting shares in escrow so as to easily implement the adjustment mechanism).

Sometimes, issues arise not in the acquisition phase but, rather, during operations. If the parties enter into a joint venture or if one company depends on payments from another, one solution may be to require the operating company to appoint the investor's person as the one controlling or co-controlling the bank accounts—which gives the investor absolute or joint control over making payments.

Similar considerations arise if the issue is a matter of receiving adequate information. This technique is used by some hotel brands when they franchise their name to a local operator, but would like to maintain control over cash and/or information.

Outbound-Extending Tax Regimes

Like FCPA and the United Kingdom's UK Bribery Act,⁷ some Asian countries have enacted extra-territorial laws. Because many transactions done in Asian countries are structured offshore, this allows the owner to sell the shares with the underlying structure without doing anything onshore, where the assets are. As a result, countries such as China and India have introduced legislation to try to tax indirect transfers of Chinese or Indian assets.

China's Circular 698⁸ legislation states that the transfer of shares in any business with significant assets in China may be subject to taxes in China. Circular 698 was enacted in December 2009 but made effective retroactive to January 1, 2008. While initially it was loosely enforced, enforcement over the past few years has become stricter. A similar situation occurred in India and resulted in a dispute between Vodafone and the Indian government. This type of legislation influences the way businesses structure how they invest in such countries.

Circular 698 does not apply to every situation. One way to eliminate or reduce its impact is if the offshore holding companies, located in a low-tax jurisdiction, have substance—i.e., are themselves operating companies. For example, Circular 698 may not apply if the offshore holding company acts as the regional hub of the Asian business, has its own employees, and conducts other activities. The analysis is fact specific and complex and requires spending money upfront, both on the legal and tax planning as well as on creating the infrastructure itself.

China's Anti-Trust Legislation

China has aggressive and relatively new anti-trust legislation. Due to its newness, there are not many published cases. And because the

⁷ Bribery Act, 2010, c. 23 (U.K.).

⁸ Guojia Shuiwu Zongju Guanyu Jiaqiang Fei Jumin Qiye Guquan Zhuanrang Suode Qiye Suodeshui Guanli De Tongzhi [Notice on Strengthening the Administration of Enterprise Income Tax on Gain Derived from Equity Transfer Made by Non-resident Enterprise] (promulgated by the State Administration of Taxation, Dec. 10, 2009, effective Jan. 10, 2008) Guo Shui Han [2009] No. 698 (China).

legislation is largely enforced with an international flavor, it may cause significant problems for foreign businesses acquiring assets or companies in the country.

In the event of an acquisition, it is important to determine whether the business must make a filing which, if required, could delay the transaction's completion by three-to-nine months and potentially much longer. This is not unlike similar competition laws elsewhere in the world.

The challenge in China, however—which is directly related to the fact that the law is relatively new—is how it is interpreted. For example, filing under the law is contingent upon the turnover of the acquiring, acquired, and seller's business, both in China and around the world, but there are certain scenarios that are unclear. Because businesses in different countries use different accounting standards that may lead to varying turnover numbers, which number should be used? How should the turnover of a PE fund be calculated? The regulations do provide that control of an entity would require inclusion but does it really make sense to include in the calculations of the business of a PE fund the revenues of all of its portfolio companies? Likewise, how does one determine the turnover of a Chinese state-owned enterprise?

As the laws develop and mature, and generate more cases, these issues will gain more clarity. For now, though, they pose significant issues for lawyers advising their clients.

Human Resources in Asia

The pace and size of business growth in many Asian countries pose significant human resources headaches for the typical multinational company:

- Obtaining and retaining talent is difficult.
- Significant training is often required and employees are feeling less of a sense of loyalty to their companies. A business can easily spend two years training someone, only to have the employee suddenly go to a competitor for a job that pays a little more.

- Differing tax regimes between countries can create significant issues. For example, a company that moves an employee from Hong Kong to China will need to address the issues associated with an employee who used to pay a 16 percent income tax now paying 45 percent.
- Labor laws differ among countries on how easy it is to hire and fire employees and enforce non-compete or other restrictive covenant clauses.

Navigating these differences requires planning and knowledge of the different places and specific industries in which the business is involved.

Conclusion

Asia includes a large number of evolving markets with evolving laws. Companies and funds seeking to conduct business and invest in the region should engage strong, experienced counsel who understand international as well as country-specific laws, regulations, and best practices, and who appreciate a pragmatic/commercial approach when dealing with issues arising from business operations and investment. It is important for companies and their international counsel to be familiar with not only legal regimes, but also real-life practicalities because, very often, there may be a significant gap between the two.

Increased and changing regulations are a significant trend that corporations doing business in Asia will face over the coming years. Regulatory, anti-corruption and other proceedings and investigations are expected to become a major concern. Accordingly, general counsels, compliance officers and attorneys in Asia should expect greater client demand for related legal services.

Key Takeaways

- Be practical when structuring and operating your business in Asia. Maintain control where needed, but bear in mind that it may not be feasible to operate a business in Asia as you would elsewhere.
- Make sure to structure deals and run businesses in ways that create an economic incentive for both parties to complete the

transaction or operate the business in accordance with the language of the agreement.

- Understand the full regulatory scheme facing your business. While this may be based on the country and industry in which the business is conducted, it also could be affected by other regulatory schemes (such as FCPA) that may be applicable to your business.
- Because enforcement of agreements and court awards can be difficult in Asia, it is best to structure deals in a way that provides a remedy that does not require outside intervention or actions onshore.

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