

Lohtsman

China Due Diligence

PwC Risk Management Seminar

Reputational Due Diligence: A qualitative look at Chinese stakeholders

28 February 2017

Agreed – there are risks to address in China

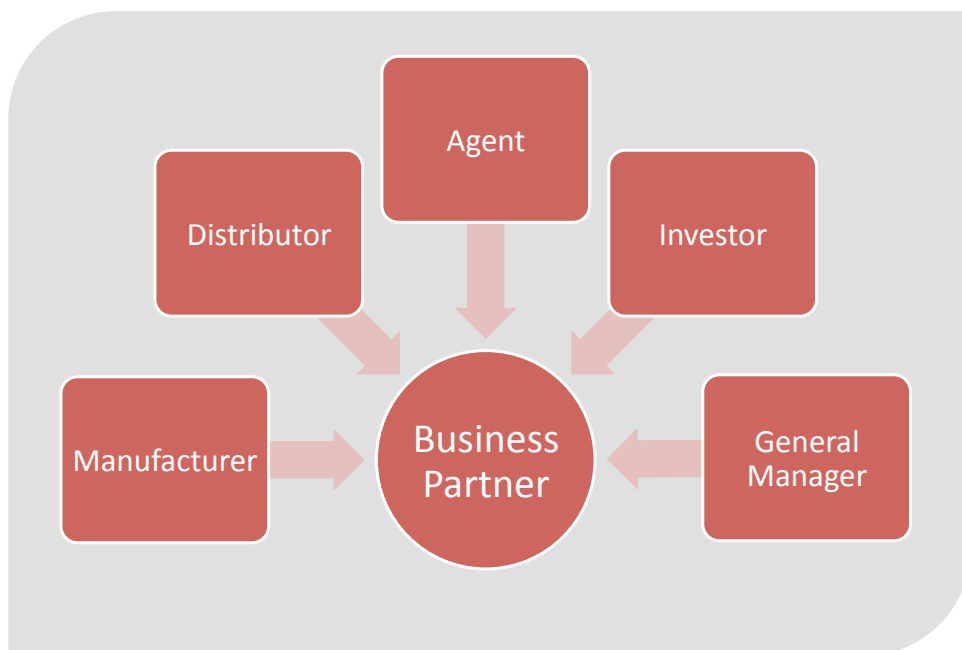
Thank you for attending PwC Israel's Risk Management seminar. I am happy to share these detailed notes for your reference.

Your being at the seminar is a testament of the growing awareness (or perhaps acceptance) that there are risks to address in China despite the sometimes overwhelming urgency to jump right into the "pot of gold" that some consider the Chinese market. One of the risks to consider is Chinese business partners.

While China continues to open up to the world, still, in many cases foreign companies are required by Chinese law to partner with a Chinese company in order to do business there. In other cases, it may not be legally required, but it might be smart.

The term "business partner" as used throughout these notes and the presentation slides refers to a company or individual somehow working on a foreign company's behalf in China.

The presentation gave a brief overview of the history and dynamics of Chinese business partnership, then discussed the details of business partner assessment using Reputational Due Diligence.



China has evolved into a different era

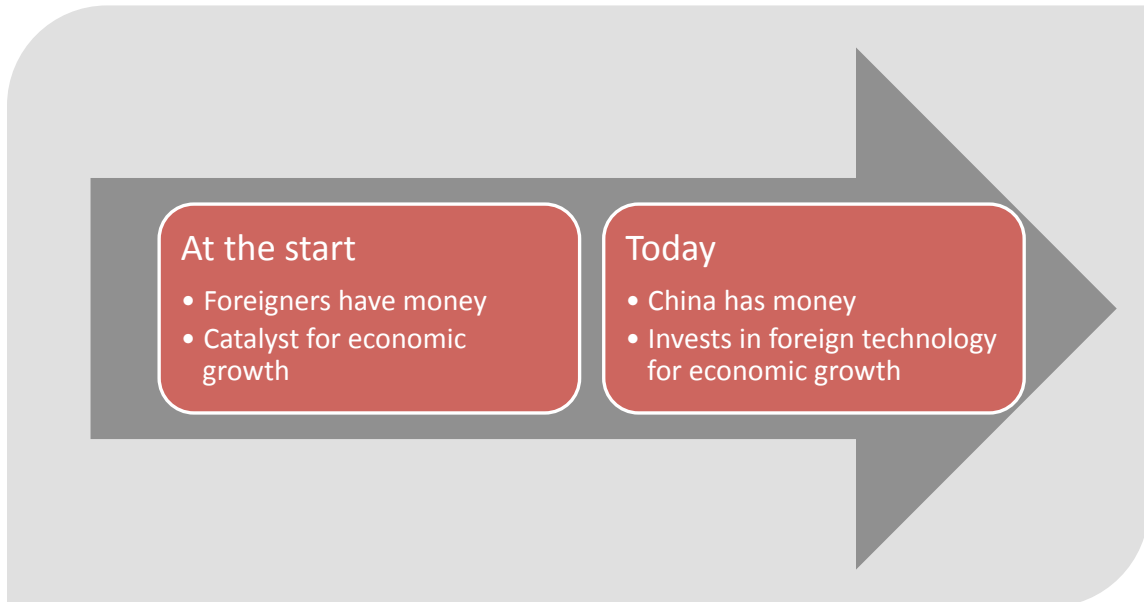
“ Socialism does not mean shared poverty. ”

– Deng Xiaoping

In the 1970s then-leader Deng Xiaoping stated, “Socialism does not mean shared poverty”. This is arguably the start of the change that made China as we know it today.

Since then, China’s economy has undergone an intense transformation in the span of roughly a generation. Naturally, the nature of Chinese and foreign companies partnering and doing business together in China has also undergone transformation.

China has evolved into a different era



At the beginning of China's intense economic growth, foreign companies came in, their pockets full of money, built factories, hired Chinese workers to make their products, and was essentially a catalyst for China's huge economic growth.

In the time up until today, there was a change from working *for* foreign companies to working *with* foreign companies.

Today, China is the one with its pockets full of money and it is looking to invest back into its own economic growth, mainly by purchasing foreign technology.

China and Israel

A perfect match

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Israel and China are a perfect business match. Israel has a huge amount of innovation and technology, and China has a huge amount of money and market size.

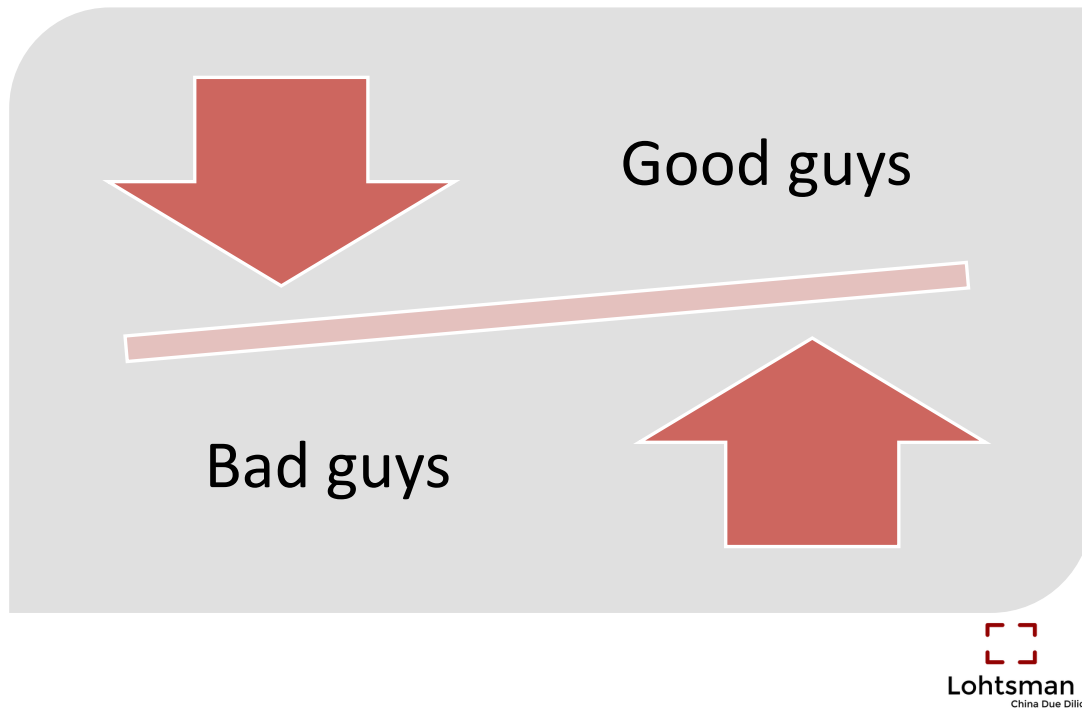
Just last year the Chinese Vice Premier Liu Yandong came to Israel and expressed that “[China] hopes that more Israeli entrepreneurs will undertake projects in China” in a variety of industries (Times of Israel).

Her statement illustrates the transformation that business partnership has seen in China; Israeli companies (or any other nationality) are not going to China to use a cheap workforce for their own gains. They are going to China to partner with a Chinese company to make money and better the Chinese society together.

As business partners, Chinese companies today generally have sophisticated business acumen. Acting as the “China side” of your business, they have the local resources and importantly, cultural understanding, which they can interpret for you or just take care of.

In terms of risk management though, keep in mind that not all Chinese business partners are created equal.

Not all business partners are created equal



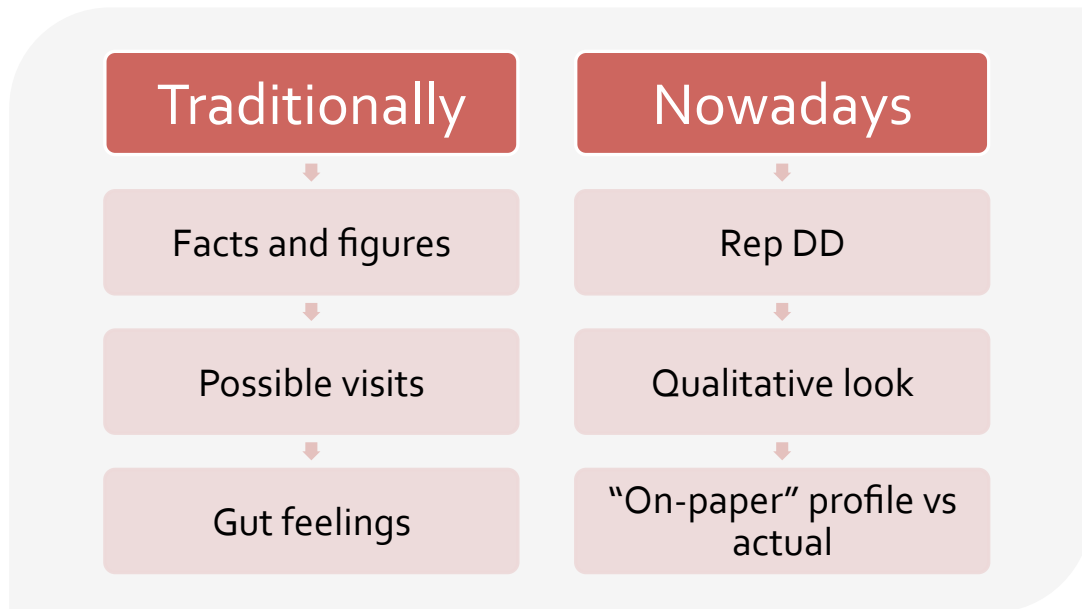
In parallel with the sheer number of people in China, the number of potential business partners there is almost astronomical.

Like in all countries, in China there are "good guys" who are honest and trustworthy, and there are "bad guys" who have as a goal to take your money (or IP) and disappear.

The "good guys" will make you successful. They will take you to the pot of gold. They will allow you the luxury of conducting your business in China without worrying about micro details that you might not even be aware of there.

On the other hand, the "bad guys" will give you the same sense of comfort and security but in the end will leave you with your pockets empty and your head spinning, wondering what went wrong and when.

Separating the “good” from the “bad”



Traditionally, foreign companies have conducted due diligence relying solely upon paperwork stating facts and figures, sometimes coupled with visits to China and good old-fashioned gut feelings.

While facts and figures may be good indicators of a Chinese business partner’s on-paper profile, the facts and figures alone rarely uncover more qualitative things, like how the company actually conducts business, reports of unethical behavior, concealed business interests, or that a potential investor actually doesn’t have the capital to back up their offer.

Nowadays something called Reputational Due Diligence (“Rep DD”) can be used to reasonably understand whether a business partner is a “good guy” or a “bad guy”. “Reasonably”, because no matter how much research you do, you can’t predict the future behavior of human beings.

Reputational Due Diligence



What is Rep DD?

Rep DD goes by many names: "reputational", "integrity", "enhanced", or "qualitative" due diligence, or even some type of "intelligence". Ultimately Rep DD identifies indications of red flags that the business partner is one of the "bad guys".

Rep DD supports other types of due diligence in that it compares the business partner's on-paper profile with its real-life activity. It identifies any contradictions between how the business partner has presented itself on paper and how it actually behaves and exists in the real world. It's also the difference between what they have told you they do and what they really do.

Rep DD can focus on either companies or individuals but usually blends the two. In the end *people* are ultimately behind companies. In China specifically there is a position called Legal Representative, which must be a natural person. This person is the personification of sorts of a company and is present to represent the company during any legal-related matters.

Rep DD is a risk management tool.

- What if your business partner has a labyrinth of related companies that you didn't know about? *Without* Rep DD you likely will not find out about these companies and there is a risk that, for example, your IP may be passed around the related companies. *With* Rep DD, you will likely find out about the related companies and you will have an opportunity to protect

your IP. It might just be a question of tightening your contract's confidentiality clause.

- What if the business partner told you they are a top distributor of your product in China? You saw their big shiny offices and luxury cars, but with Rep DD you find out they are a 3-person intermediary agency.
- What if the business partner's company chop doesn't match the company registration info? This sounds simple, but it could have legal implications down the road.

Rep DD looks beyond the surface to unearth a business partner's "true story."

In addition to being a risk management tool, Rep DD tends to also strengthen negotiations with Chinese business partners with the knowledge you obtain.

When and Why do you conduct Rep DD?

There are two general points in time that you would do Rep DD: before bad things happen, as a *preventive* measure; and after bad things happen, as a *reactive* measure.

Rep DD as a preventive measure

- Business partner *on-boarding*
Checking out the business partner before you entering into contract.
- Business partner *monitoring*
Making sure the business partner hasn't changed since you entered into contract with them.

Preventive Rep DD answers questions like:

- What is the ownership structure / who is the ultimate owner?
- Does the company show signs of actually operating?
- Does it legally exist?
- Does anything contradict what the business partner has told you?
- Does the business partner really have experience in my industry?
- Are there any outside business interests that would be risky to me?
- Does the investor really have the money?
- Does my future general manager have a criminal history?

Preventive Rep DD is also useful for making a paper trail, either for your company's internal policies, or for legal reasons. Some companies may be subject to certain regulations in their home country, such as anti-bribery/corruption laws, anti money laundering laws or even tax laws. Depending on your company's home country these laws may reach you in China. For example, several countries have anti-bribery laws that require you to "reasonably" understand your Chinese business partner's activity and how it pertains to risks of bribery. When a government agency comes knocking at your door saying you are engaging in bribery via your Chinese business partner, in certain jurisdictions it may be a strong defense argument to present a recent Rep DD report stating that at the time of research there were no indications that the business partner was of high risk. *(Based on my*

observations, please do not take as legal advice).

Rep DD as a reactive measure.

Unfortunately, sometimes unpleasant surprises do happen with Chinese business partners.

Reactive Rep DD may be conducted to come to terms with what happened or understanding why, or perhaps it might be a starting point for developing internal policies to lower risk of the same thing happening again.

Perhaps the biggest reason for reactive Rep DD is suspected wrongdoing. This is my primary experience, and the most common theme is “undisclosed business interests”. These are extremely easy to miss in other types of due diligence, on Chinese companies specifically. There are numerous cases where owners of Chinese companies have registered related companies in family members’ names. Chinese husbands and wives typically do not have the same last names. So throughout a family this leaves much opportunity to establish a group of companies that appear unrelated but that are actually quite close-knit. This is an example of where the *qualitative* aspect of Rep DD comes in.

People tend to leave traces of themselves everywhere, especially in the age of the Internet. Rep DD practitioners will use these traces to connect the dots and find fact-based information connecting related individuals and companies.

Reactive Rep DD may also be useful in providing information in litigation proceedings. Generally speaking and depending on many factors, Rep DD findings may serve as some sort of support for a legal argument in the form of a character profile of the business partner or related individuals.
(Based on my observations, please do not take as legal advice).

How do you conduct Rep DD?

Rep DD is a qualitative look at a company, so using an investigative mindset while doing the work is key.

Rep DD in China is conducted differently than it would be in other parts of the world. The reasons are both practical and legal.

Practically speaking, Rep DD in China is largely “manual” work, meaning there is no software that will effectively run a simple search with the company or individual’s name and bring up all relevant information. This works in some places in the West but not in China. “Manual work” requires first finding puzzle pieces then putting the pieces together.

Also practically speaking, whatever information is available in China may be provided differently than in other parts of the world. Information tends not to be centralized in China but is organized on a city or provincial basis. Even within official corporate or legal records, a certain category of information available in one province may not be available in another province.

Further, the approach to Rep DD on individuals in China is different. This is because there are

relatively few names for the relatively large population. To quantify it, there are around 1.5 billion Chinese people. Around 22% of the population has one of three last names: Li, Wang, or Zhang. That's 330 million people (about the population of the US), and that's only mainland Chinese. Add to that Hong Kong, Taiwan and other Southeast Asian Chinese names. Searching a Chinese person's name alone returns literally millions and millions of false positives that have nothing to do with the individual being researched. It takes cultural understanding and investigative skills to narrow down the false positives to get any kind of meaningful information.

Legally speaking, Rep DD in China is conducted differently because of laws protecting what is called "personal information" and what is called "state secrets". In terms of Rep DD, information should come from publically available information sources. There are Rep DD firms that obtain what is considered non-publically available information, and that is illegal and extremely risky to all parties involved.

It may seem that using only publically available information sources would limit the effectiveness of Rep DD and the results you might find. I disagree. This is where finding the puzzle pieces and then putting them together comes in. Rep DD practitioners filter through huge amounts of information, and connect the dots to identify things like criminal or civil litigation, misuse of government subsidies, outside business interests, and any other reputational "red flags".

In that way Rep DD uncovers rather interesting information despite what may be perceived as obstacles or limitations.

From both a practical and legal perspective, keep in mind that in China, information not available today may be available tomorrow, or more often vice-versa.

Who should conduct Rep DD?

Why the topic of who should do the work? So that your Rep DD risk management tool is effective, and not an expensive waste of time.

More and more foreign companies are requesting Rep DD from service providers, because the work is not easy. Companies want the most valuable information, quickly. If you do consider engaging a Rep DD service provider, what should you look for?

- Specialists in China Rep DD or at least a Rep DD firm with a designated China Rep DD team. Rep DD is different in China.
- Within the China Rep DD team, there should be experienced practitioners who understand the environment in China and who can integrate native understanding of the *culture* (not just language). It's not about the language but about looking at the information in front of you and analyzing what it *really* means with regards to a particular case.
- Understand how the Rep DD service provider conducts research in terms of using publically available information sources. Taking photos or obtaining corporate information from a third party are in some cases *not* publically available information sources.

Thank you!

I am more than happy to discuss any questions on Rep DD or items relating to your particular China goals. Feel free to contact me at my details below.



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Laura is Founder of Lohtsman where she assists clients with Business Partner Reputational Due Diligence and China Market Pre-Entry Strategy.

A Forensic Accountant by training, Laura's background is in fraud investigation, having specialized in reputational due diligence on Chinese business partners. She has overseen hundreds of cases from FCPA compliance to investigating undisclosed Chinese business interests, having identified important "red flags" which otherwise would have gone unnoticed.

Laura was born and raised in Nashville, Tennessee, USA. She spent 10 years in France and over 5 years in China before moving to Israel in August 2016. She has a Masters degree in Forensic Accounting from Florida Atlantic University and is a Certified Fraud Examiner.

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