Conduct a thorough due diligence of your China business to ward off misbehaviors

Description

I have not realized the necessity of doing such a checkup till a client approached me just recently requesting me to help with such a due diligene on their WFOE in China with a view to seeing and understanding whether the business is being operated in good manners and in compliance with Chinese laws and to finding out whether the management team have done their job correctly or have done anything wrong or unethical.

The client's request immediately reminded me of another case not long before in which the foreign boss discovered that her right-hand person, a Chinese lady, who is expected and supposed to safegard and folster the growth of the business, had been taking every possible opportunity to gain personal interests from company's business transactions. Here is the post briefing the case: manager your manager.

It is the common sense that for a business, its management is vital to its life and death. So the people on the management team are most important and critical element for the business success. It is a great fortune for a business to have the most capable, diligent and LOYAL people on the management team; it is not that bad if you have people who are not very smart and capable but still LOYAL to you; but it is always most unfortunate if you have people who are DISLOYAL, and it is even worse for the business if these people are smart at the same time.

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Loyalty is the most desired attribute of a person in a fiduciary capacity. It is a worldwide concern in corporate practice. In China Company Law, duty of loyalty is placed ahead of duty of diligence for senior managers.

The problem of loyalty is more acute in situations where foreign nationals are appointed on the management team, as in the case of a China foreign invested enterprise, for instance, a WFOE, whereby the foreign shareholders may have employed local Chinese managers in order to localize the business. But it is in most cases a tremendous challenge to build trust between western business people and their Chinese countparts, esp at a time when high-profile disputes such as Wahaha versus Danone broke out. In such a case, it is always a big concern for the foreign investors whether their managers in the WFOE have been done the right things.

So the question comes to how foreign investors can gauge, assess and determine whether their management team are being, in the first place, LOYAL. One possible answer is a thorough due diligence (DD) in both legal and financial perspectives on the work that has been performed by the management in the past.

The due diligence should focus on certain areas and points:

(1) whether the management have performed their duties in accordance with the company's articles of association and bylawys; presumably, the foreign invested company should have a well-drafted articles

of association and bylaws;

(2) whether the management have employed any relatives to work in the company, and what are the terms of such employment;

(3) whether the terms and conditions in major contracts are reasonable and fair, esp in company's supply and procurement contracts where managers may be engaged in self-dealing, receiving rebate and kickbacks;

(4) whether corporate funds are misused or appropriated or even embezzled;

(5) whether there are unreasonable reimbursements or disbursement of funds to the managers.

There are other points to the list.

A thorough and careful DD or checkup of the business operation can and will dig up and find out misconducts on the part of the management, which may save big losses to the company and its shareholders.

Periodical DD are more necessary to institutional investors such as various funds and foundations that invest the money raised from their investors, because such institutional investors tend to exercise less control or be less involved in the business operation in a foreign country.

We welcome you to contact us for more in this regard.

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