

Knowing Your Partners in China



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1. The Importance of Finding the Right Partner in China

When contemplating whether or not to do business with China¹, you, as an EU SME, have many choices. You may choose to simply export from Europe, use a distributor in China, establish your own office/manufacturing base in China or a combination of these. However, no matter what you do, you are likely to be confronted with the option of working with a local partner.

Working with a local partner has a variety of advantages and, if not careful, possible disadvantages. It is important to stress that the vast majority of companies in China are honest and willing to develop sustainable business. However, just as important as whether to partner or not is the question: How to find, and assess, the right partner?

This report will help answer this question.

Introduction to the EU SME Centre Starter Kit

To help European SMEs entering the Chinese market with an informed decision, the EU SME Centre has published a series of diagnostic business tools entitled *Are you ready for China?* Four reports on different aspects of market entry are accompanied by an online quiz tailored to help entrepreneurs check their level of market readiness and point them towards further resources to improve understanding of lesser known business areas. The series is designed to work as a step-by-step introduction to the Chinese business environment, allowing SMEs to gauge their preparedness in doing business in China.

This report, *Knowing your partners in China*, is the last in the series of four to aid EU SMEs understand and enter the China market. It serves as a concise guide to due diligence in China, from verifying a company's administrative and legal standing to checklists for visits to the partner's premises, it covers all areas of basic due diligence. It also offers a variety of case study examples, practical recommendations and references for further information.



Online quiz - *Gauging your readiness*: This electronic learning module will help you assess your knowledge of the Chinese business environment.

Report 1 - *Is China on your radar?* A general introduction to China's macroeconomic framework and what it means for European SMEs, including specific opportunities by industry sector.

¹ For the purpose of this report, by "China" we mean Mainland China; Hong Kong and Macau have different legal systems from Mainland China although they are part of the Chinese territory politically.

Report 2 - *Ways to enter the Chinese market*: An overview of different modes of entering the Chinese market, from exporting to investing, from joint ventures to wholly foreign-owned enterprises.

Report 3 - *Exporting goods, services and technology to the Chinese market*: A closer look at import regulations and processes, including practical tips and best practices.

Report 4 - *Knowing your partners in China*: A concise guide to due diligence in China, from verifying a company's administrative and legal standing to checklists for visiting the partner's premises, this guide covers all areas of due diligence.

To find out more, please visit www.eusmecentre.org.cn/diagnostic

1.1. What is Due Diligence and Why to Conduct It?

The best way to make the right choice for your business is through **due diligence**. Due diligence, in its simplest form, is the act of evaluating a prospective business decision by getting information about the financial, legal, operational and reputational state of another party.

Due diligence that is well researched and conducted on a potential partner can help you avoid a number of common China partnership pitfalls, such as:

Fake Companies

- A potential partner may not exist at all.

Paper Tigers

- A potential partner may promote itself as a leading company in its industry but is an imposter or does not really exist.

Shell Companies

- A potential partner may possess all the required registration information but no significant assets or active business records.

Parasite Companies

- A potential partner may rely too heavily on its relationship with local government officials. The company may be operating in a legally grey area, vulnerable to changes in government personnel.

Opportunistic Companies

- A potential partner may have good intentions but lack experience and is overly optimistic about its own abilities, often coupled with a mistaken belief that cutting corners and operating in a legally grey area is possible. Almost invariably, the partner is unable to live up to its part of the bargain.

1.2. Types of Due Diligence

There are different types of due diligence when selecting a business partner in China. Each is equally as important and must be completed effectively to ascertain that your China market entry won't yield any unwanted surprises.

The due diligence to be undertaken is:

1. Checking a company's administrative and legal standing.
2. Checking a company's financial standing.
3. Checking a company's operations and track-record.

Sections 2, 3, and 4 of this report will take a closer look at the three categories of due diligence. Now, this report presents the **seven rules of due diligence** that should always be on a company's mind.

1.3. Seven Rules of Due Diligence

Rule 1: Assess how Chinese Companies Treat Partner Companies

- It is harder for Chinese companies to mislead other Chinese companies, and there is less incentive to do so.
- Strive to learn how other Chinese companies treat (and are treated by) your potential partner company.

Rule 2: Do not Take Company Introductions at Face Value

- It is better to make introductions through your own trusted networks and advisors than through your potential partner company.
- Suppliers, competitors, employees or customers involved with the partner company may have an agenda that benefits the partner company (and may even be part of a scheme).

Rule 3: Always Ask Yourself, "Is This Too Good to be True?"

- Remain vigilant throughout your due diligence.
- Always be prepared for plain fraud.

Rule 4: Scrutinise the Company Operations

- The partner company may send you paperwork that is inaccurate at best and fraudulent at worst.
- The best way to know a company's true identity is through assessing its business operations (due diligence stage 3).

Rule 5: Scrutinise the Company's Paperwork

- Always be on the lookout for mistakes, such as names of banks, locations, customers, suppliers, logistics, and production amounts (due diligence stages 1 and 2).
- Verify key information through multiple sources (it is hard to manipulate every source).
- A mistake may seem honest, but it may also be a crucial clue to the company's legitimacy.

Rule 6: Speak to Other Stakeholders

- A multilevel check: have competitors, suppliers, regulators, expected customers and industry media even heard of the company? If so, what is the company's reputation?

Rule 7: Do Not Delegate

- Business subordinates may have reasons to conspire with the potential partner company, (see stage 2).
- Make sure your decisions are based on **your own conclusions** reached by consulting different independent sources.

2. Verifying a Company's Administrative and Legal Standing

The questions you must first ask before partnering with a business in China:

- Is the company duly incorporated?
- Is the person I am negotiating with authorised to represent the company?
- Has the company obtained all permits and licences required for the business it performs and are those permits valid?
- Is the company entitled to use the premises or land it occupies?
- Does the company legally own the intellectual property rights – trademarks and patents – it claims?

This chapter will tell you how to find the answers to these initial questions.

2.1. Business Licence

Every company legally incorporated in China possesses a **business licence**. It is an official document issued by the **State Administration of Industry and Commerce** (SAIC; 国家工商行政管理总局) and acts as the company's identification.

2.1.1. Checking the Online SAIC System

The easiest way to check whether a potential partner holds a business licence is to check the online company registration system of the SAIC (<http://gsxt.saic.gov.cn/>). This website is available only in Chinese and appears as follows:



When searching for a company, perform a search on the Chinese company name, the unified social credit code, or the company registration number. It is important to obtain the full Chinese name of your potential partner; should the company claim that it has only an English name, by definition, it is not incorporated in China.

When searching the online SAIC system, the following company information can be found:

1. Company Name

- The name online must exactly match the name of the potential partner company.
- Every document during the due diligence process must have exactly the same **Chinese** name, including the business licence, company stamp and bank account.
- A company name usually consists of four parts: “trade name + industry + (city) + Co., Ltd.” or “city + trade name + industry + Co., Ltd.”

2. Company Address

- The address must correspond to a real place of business.
- An unannounced visit to the premises is recommended.

3. Legal Representative

- The legal representative is the person authorised to represent the company to third parties (e.g. sign contracts on behalf of the company and affix the official company stamp).
- It is acceptable to ask for the ID of the person who claims to be the legal representative.

4. Registered Capital

- The registered capital sets the limitation of liability of a company’s shareholders.
- A low registered capital may be an indication you are dealing with a shell company.
- Since the New Company Law came into effect in March 2014, investors have more flexibility to contribute capital, so the legal requirements for a minimum capital and paying the registered capital within a certain time limit have been abolished (except for certain industries).

5. Unified Social Credit Code

- Each company shall have one unified social credit code which is composed of 18 numbers or numbers and capital letters.
- The unified social credit code of a company plays the function of “digital ID certificate” of the company which remains unchanged throughout the existence of the company.

6. Term of Business and Date of Establishment

- Note the term of business/business licence expiration date.
- If the potential partner has been recently established, this may indicate the potential partner has a limited track-record/experience.
- Limited information will be available if the company has been established for less than 6 months.

7. Form of Incorporation

- Usually limited liability company.

8. Business Scope

- Make sure the company's business sector and activities in which you are going to cooperate, are included in its scope of business.
- This can help identify the permits and licences required and those still needing applications.

9. Shareholders

- Check whether the persons claiming to own the business are actually listed as shareholders.

10. Management Team

- The company should list the identities of its directors, supervisors and general manager.
- Use this information to verify you are indeed dealing with the company's directors.

11. Company Status

- A company's status can be: "existing", "business licence suspended", "deregistered" or "moved out".
- Deregistered means that the company no longer exists, while a suspension is usually the result of the company having violated certain laws or regulations.

12. Abnormal List/Blacklist

- Website shows if a company is on AIC's abnormal list/blacklist (lists are not always up to date!).
- Abnormal companies failed to make filings, filed incomplete/incorrect information or could not be contacted; for blacklisted companies, this has been the case for 3 years in a row.
- Such administrative non-compliance doesn't automatically make a company suspect, but it is a signal that one should be careful (especially if the company is blacklisted).

2.1.2. Checking the Business Licence

Although the online SAIC system is usually up to date, there are no guarantees. Therefore, this information should **always** be confirmed by official documents.

The key document for such verification is the potential partner company's business licence. You should always demand a copy of a company's official duplicate business licence with the official company stamp (also known as a "chop") affixed to it. Note that the original business licence is often hanging on the company's wall, so anyone would be able to take a picture of it, while the duplicate licence is usually stored somewhere safe.

The following information that you initially found online (explained earlier) can and should be verified on the basis of that company's business licence:

- | | |
|-------------------------------|---|
| 1. Unified social credit code | 5. Registered capital |
| 2. Company name | 6. Term of business and date of establishment |
| 3. Company address | 7. Form of incorporation |
| 4. Legal representative | 8. Business scope |

Example of a duplicate business licence



On the business licence there is also a QR code. Scanning the code leads to the company information in the online company registration system of the SAIC.

2.2. Company Stamp

To be considered official, any document in China needs to be affixed with a **company stamp** or **chop**. The company stamp is the “official signature” of the company and must be affixed on every important document you receive. The importance and use of the company stamp in China is the same as the signature of the CEO or general manager in Europe. Without it, the document can be easily questioned as not being official.

Two important questions need to be asked about the company stamp when finding a business partner in China:

- Is the company stamp genuine?
- Has it been used by the authorised company representative?

2.2.1. Confirming the Validity of a Company Stamp

1. Go to SAIC and the Public Security Bureau (公安局) Where the Company is Located

2. Ask Whether the Company Stamp is Registered

- Registration of a company stamp at the Public Security Bureau is mandatory.

3. Inspect Various Documents Filed With Local Authorities

- Ensure that the same stamp has been used on all documents.

4. Only if the Stamp is Registered or It is Used on all Filed Documents Can You be Sure It is Valid

It is vital to confirm the validity of a company stamp to ensure that your potential partner is a legitimate business; this can be undertaken effectively only by local Chinese lawyers (even for them, it may be difficult). In some cities, the local Public Security Bureau maintains a website where it is possible to search for images of registered stamps; however, a physical check of course provides more certainty.

In several cities, the Public Security Bureau is known to be uncooperative when it comes to verifying chops. If this is the case, the **alternative** is to compare the chop with the chop used by the company itself on official documents filed with the local SAIC (see 2.2.4 on how to obtain such documents).

2.2.2. Confirming Authorised Use of the Company Stamp

1. Visit the Company HQ

2. Ask: “Is the Person Who Stamped this Document Employed by Your Company?”

3. Ask: “Is that Employee Authorised to Undertake this Particular Business?”

4. If Both Questions are Answered Affirmatively, then Use of the Company Stamp was Authorised

An **alternative method** is to require the **legal representative** of the company to sign next to the chop. Since the legal representative is authorised by law to represent the company, there can be little doubt whether the stamp’s use was authorised in such case.

To ensure the signature is indeed that of the legal representative, ask the person signing to identify him or herself and compare the name on the ID card with the one stated in the online SAIC database (note that it is not uncommon for Chinese people to have exactly the same name). Another method is to compare the signature with the signature of the legal representative on official documents that the company itself has filed with the SAIC (see 2.2.4 on how to obtain such documents).

2.2.3. How the Stamp Should Look

When looking at stamped company documents, ensure that the stamp on the document is:

- Circular (sometimes oval);
- In red ink (almost always, with very few exceptions);
- The company name is in Chinese characters only (although some companies show the name in both English and Chinese); and
- Completely legible.
- In most places a 13-digital number appears on the chop.

Examples of an official company chop:



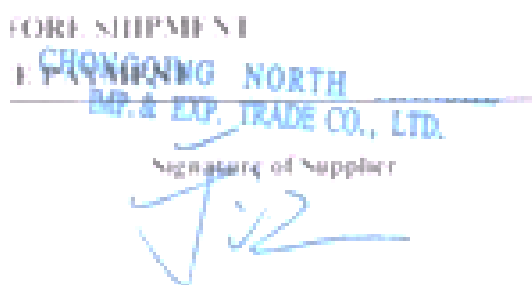
Some examples of how an official Chinese company chop does **not** look :

For and on behalf of
COMMON SEAL CO., LTD.

.....
Authorized Signature(s)

Holding Co., Ltd
 Hong Kong

Some further examples of how an official Chinese company chop does **not** look:



2.2.4. Researching the Company at SAIC and its Branches

Accessing a potential partner company’s records through SAIC and its local branches is not easy, but it will provide you with more reliable and accurate information than would be provided by basic company search firms.

To successfully obtain a company’s records from SAIC:

1. Hire a Chinese Lawyer

- SAIC has been known to open up records only to licenced Chinese lawyers (even lawyers may have difficulties accessing SAIC files in certain cities).

2. The Lawyer Should Visit the SAIC Office in Person

3. Review the Company File and Make Copies at the SAIC Office

- All documents will be in Chinese. Hiring a translation service is advised, usually through the hired law firm.

SAIC usually releases the file upon request, but there is a chance that an SAIC office may block research on a file of a powerful partner company.

2.3. Permits and Licences

Certain business activities require **special permits** issued by different state authorities, usually responsible for supervising the related industry.

By looking at the business scope on the business licence, you will get a better understanding of the permits to request from your potential partner. Study them with the same attention to detail (e.g. company name, date, stamp) as you did the business licence.

Be aware that for an investment into certain industries/businesses, there is an obligation to establish a joint venture (JV) with a Chinese partner with a prescribed limit of foreign investment.

Permits needed may include:

- For an **importer** or **exporter**: import or export licence (foreign trade operator filing form);
- For a **supplier**: special permit for manufacturing the product;
- For a **distributor**: distribution permit (for certain products a special distribution permit is needed, e.g. food);
- For a **service provider**: permit to provide a specific service (often included in the business scope on the business licence);
- For a **manufacturer**: Site related opinions, such as an environmental assessment report or operating permits.

Kindly note that, starting from October 2016 in China, a combination of five certificates (business licence, enterprise code certificate, tax registration certification, statistics registration certificate, and social insurance registration certificate) were merged into one business licence with one unified social credit code. Although the five certificates are combined into one (business licence), in practice after obtaining the business licence, a company also needs to submit paper documents to relevant authorities (quality supervision bureau and tax bureau etc.) for the filing. Just that these authorities will not issue the other registration certificates.

Check in the online system of the Ministry of Commerce (“MOFCOM”) (<http://iecms.mofcom.gov.cn/>) and that of the State Administration of Taxation (the <http://www.yibannashui ren.com/>) to see if the potential partner company has filed with MOFCOM for the foreign trade operator qualification and registered as a VAT general taxpayer.

Check online regarding whether an import/export company has been properly registered with the customs authorities: <http://www.customs.gov.cn/publish/portal0/tab9408/> (Chinese only).

For further information or specific enquiries on permits and licences, please contact the EU SME Centre.

2.4. Premises and Land

The following questions need to be answered in relation to a potential partner company’s premises:

- Do they have the right to use the land?
- What rights do they have over the land?
- What can the land be used for?

2.4.1. Land Use Rights

Land-related rights and its use can be checked at the **local land and resources bureau**². However, state-owned enterprises (SOEs) do sometimes not possess land use rights certificates, in which event they must be asked to obtain one and then show it to you.

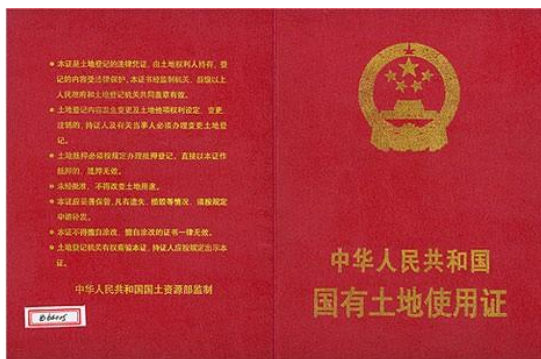
Two types of land-use rights exist in China:

- **Allocated Rights:** the right to use the land for a period of years. This means that any structures or additions to the land will not benefit the user but the landlord. Further, if the lease is solely between the Chinese partner and the landlord, it is worth having agreements in place – such as letters of intent – that ensure you can stay on the land if the Chinese partner defaults on rent.
- **Granted Rights:** title to use the land for a limited timeframe. This is the more secure of the two rights, especially if you are making a significant investment in the land. Granted rights can be used to gain a loan from a Chinese bank, and a profit can be made on the eventual sale.

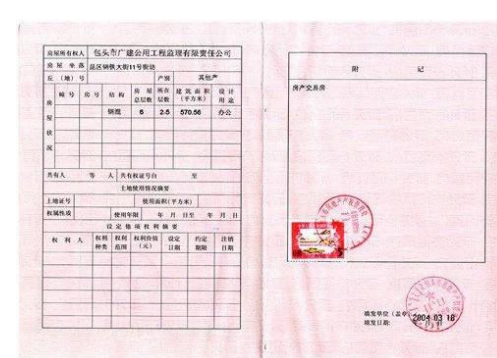
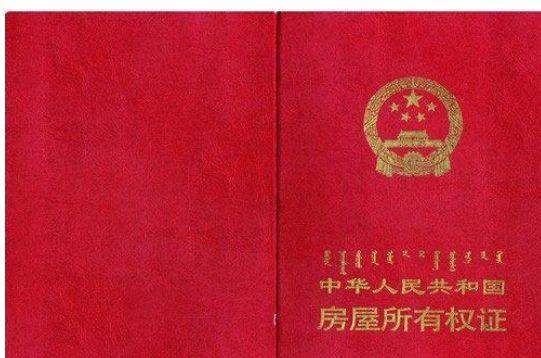
2.4.2. Premises

You need to ask for the valid **lease contract** (check the specification of premises and clauses about the term of lease), **property purchase contract, certificate(s) giving him the rights to use the land and to property ownership**. Ensure that the designated use of the land is in line with what you plan to use it for, e.g. commercial or industrial.

Previously State-owned land use rights certificate and property ownership certificate were issued to prove the land use rights and the property ownership respectively.



State-owned land-use rights certificate



² It has been changed to local natural resources bureau as the Ministry of Land and Resources has been changed to be the Ministry of Natural Resources due to the State Council's Institutional Restructuring in March 2018.

Property ownership certificate

Starting from March 2015 in China real estate certificate began to be issued, and issuance of state-owned land use rights certificate and property ownership certificate stopped though those already issued can still be used now.



Real estate certificate

2.5. Intellectual Property Rights

Your potential partner company may have trademarks, patents and/or copyrights. The exact nature of these rights should be checked, ensuring that they are properly protected and legitimately owned or licenced by asking for the company's **intellectual property rights ownership certificates**.

Registration information regarding trademarks can also be checked on the official website of the Trademark Office of SAIC (<http://sbj.saic.gov.cn/sbcx/>) (Chinese only).

For further information or specific enquiries on intellectual property in China, please contact the IPR SME Helpdesk at www.china-iprhelpdesk.eu.

2.6. Checking the Identity of Individuals

When there is a need to confirm the **identity of an individual** (either in his/her personal capacity or in the capacity as a company's representative), the best way is to ask for this person's Chinese ID card (each Chinese adult citizen should have this ID card; note that a large number of Chinese people do not have passports).

Check the Ministry of Public Security (中华人民共和国公安部) online database to see whether a certain name matches a certain ID card: <http://www.nciic.com.cn/framework/gongzuo/index.jsp> (Chinese only). The main purpose of checking is to confirm whether an ID card could be fake. This website is accessible only by certain pre-approved companies with a legitimate business need to conduct these checks (e.g. some Chinese law firms)

3. Verifying a Company's Financial Status

Inaccurate financial reporting is common in China to the extent that many companies possess two or even three sets of books: one for the tax bureau, one for investors and one for senior executives. This is mainly to avoid taxes, but the practice can cast shadows over the true financial health of a potential partner company. It is therefore tricky (yet vital) to learn the accurate financial position of the potential partner.

Two important questions to ask are:

- Is the partner company's capital/liability sufficient?
- What is its current financial situation?

3.1. Company Capital and Liability

Company liability is determined by the amount of registered capital on the business licence. It is important that you are satisfied with the limit of liability and that it adequately covers your business operations.

Registered capital is not necessarily paid upon issuance of a business licence in China. To confirm the paid-up capital, ask for the **latest audit report**. If the company was established prior to the March 2014 PRC Company Law, it should also be able to provide **capital verification reports**. However, as stated previously, this confirmation does not mean the capital is still in the company.

3.2. Financial Statements and Audit Reports

A standard request to verify a potential partner's financial standing is to ask for a **creditworthiness letter** (also known as a **bank reference letter**) issued by your partner's bank. It will give you a picture of the company's current financial situation. However, your potential partner will have to consent to this disclosure and sign relevant bank documents before the bank will release such information. If your partner is serious, it should understand and expect you to be making such requests.

Obtaining creditworthiness letters on behalf of the company's shareholders is also recommended.

In China, listed companies have the statutory obligation to disclose their audited financial statements annually, and such information can be obtained from public resources online. For companies which are not listed, **audit reports** and **financial statements** are documents seldom shared at the initial stages but can be requested as the situation allows it or obtained directly through the local AIC (note that such information at the local AIC level tends to be dated). If these documents cannot be obtained officially from the AIC and the company has not been audited, be cautious: the company may not present its true financial situation. Please also kindly note that such information obtained through the local AIC can only be used for reference since starting from 2014 annual inspection was changed to be annual report and AIC authorities expressly state that it is the companies that should be responsible for the authentication and lawfulness of financial statements submitted by them to AIC authorities for such annual reports.

A potential partner company's **credit history** can be obtained from the **People's Bank of China's Credit Reference Centre** upon application by the partner company.

Obtaining financial information about your partner without written legal cooperation is quite difficult, but there are several **investigation companies** that could assist you. However, note that some of them operate in a grey area; make sure they are not breaching any laws when conducting the investigation.

It is important to ensure that the bank account the partner company provides is a company account, not a personal one, and it should be listed with the exact name as the company's name.

It is advisable to hire a professional accounting practice with experience in China. Please refer to the service provider database on the EU SME Centre's website: <http://www.eusmecentre.org.cn/service-providers>.

The Supreme Court maintains an online database showing individuals and companies who have not complied with certain court orders: <http://zhixing.court.gov.cn/search/> (Chinese only), which can be searched by name or ID number. Inclusion in this list (which is incomplete) is an indication that your counterparty may have a history of noncompliance with court orders and may be disinclined to live up to contractual obligations. In addition, a judgment disclosure platform <http://wenshu.court.gov.cn/> was set up by the Chinese Supreme Court online which publishes judgments issued by the people's courts at all levels.

4. Verifying a Company's Operational Status

You cannot know whether a Chinese company is truly what it claims it is and can provide you with essential information unless you investigate its operations.

Here are the important questions to ask:

- Are the premises and equipment appropriate for the business the company performs?
- What do the company's suppliers, competitors and customers say?
- What is the company's verifiable track record/relevant experience?
- What is the company's organisational structure?
- What is the number of employees and management and what are their qualifications?

4.1. Visiting the Partner's Premises

It is important to visit every one of your potential partner's business premises – including factories, offices and warehouses – a number of times, both announced and unannounced, to analyse the company's daily business processes.

This will help ensure that the partner company:

- Is legitimate.
- Matches the business scope on its business licence.
- Can fulfil your business requirements.

4.1.1. Premise Visit Checklist

When visiting a partner company's premises, bear in mind the following:

1. Organisation

- Understand the entire workflow.
- Does it make sense? Can the company do what it says it can do?
- Are there any bottlenecks?
- Ask questions. If answers are not forthcoming, it is a warning.

2. Quality Control

- Number and location of checkpoints.
- How are rejections handled?
- Can you understand the reasons for rejections?

3. Cleanliness

- Cleanliness will tell you a great deal about the partner company's attitude towards quality, reputation and business relations.

4. Employee Conditions

- If employees are treated fairly and with respect, it is likely that company's business partners will be too.
- This is also a guide to the quality of business operations.

5. Machinery

- Ask detailed questions, such as what each machine does, where they are from and how old they are.

6. Location

- Are the premises close to suppliers, warehouses, distributors?
- Are the premises near a port, logistics infrastructure?
- Check utility quotas on electricity; this may affect production.

4.1.2. Talk to Stakeholders

Just before, during and after your visit, it is important to talk to the potential partner company's:

- **Employees** – at all levels, including entry level staff, mid-level managers and so on.
- **Neighbours** – they may have spotted suspicious activity or know about the partner company's history.
- **Competitors** – they will have inside knowledge on how the partner company operates. If they have not even heard of the company, something is wrong. However, do not consider information as fact when it's from a competitor.
- **Suppliers** – they will know about the partner company's supply chain and any inefficiencies.
- **Customers** – paying customers will give you one of the best ideas of how the company's products or services are truly perceived.

- **Regulators** – check the local environmental bureau, AIC and related government organisations for additional information.
- **Industry and trade associations** – these groups may be able to provide information on the status of the company within the community and industry.
- **Media** – media coverage of the company and discussions with journalists may also provide insightful information.

While you may not have time to conduct checks with all these stakeholders, professional service providers that can do this for you.

4.2. Verifying the Company's Organisational Structure

To get a true picture of your potential partner's operational success, you need a clear understanding of its organisational structure.

To verify the company's organisational structure, check the following:

All Investors and Shareholders are Mandated

The Company's External Organisational Structure

- Domestic and overseas subsidiaries, representative offices, branches, distribution centres, research operations and other associated enterprises.
- Appropriate documents evidencing proper establishment and operations.

The Company's Internal Organisational Structure

- Full names, age and contact details (if possible) of members of any supervisory board, board of directors, senior management and other key personnel.

Company Manuals, Rules and Policies

Details of Meetings

- Minutes of meetings by board of directors, general shareholders, any supervisory board and any committees in the last 3 years.

Constitutional Documents

- Shareholder agreements, JV contracts, articles of association, government approvals and registration documents.

5. Practical Due Diligence Tips

Do Not Engage If:

- The company wants you to move too fast.
- The company's offering is considerably cheaper than market average.

Bank Account

- Check details several times from different sources before wiring payment.
- Is the name the same as in the contract?
- Is the account number the same on all invoices?
- Pay to another or new bank account if confirmed in writing with the company stamp.

Contact Details

- Website: ensure it is in Chinese and English. Are contact details consistent?
- The company email address should not be a public one, for example, Yahoo163.com.
- Try calling the fixed phone line a few times.

Communication Style

- Is it consistent?
- Do they sound distracted or defensive?
- If all correspondence is related to an action that you must complete, this is a warning sign.

Contact Person

- Has the contact person changed?
- Is the person helpful or obstructive?

Business Discussion

- Do they thoroughly understand their business?
- Do they have a verifiable track record?
- Are their claims consistent?

5.1. Case study

Santé: A Case Study on Partner Due Diligence

Santé, a French pharmaceutical company, was considering a JV with Henhao, a Chinese pharmaceutical company in Wuhan, to manufacture and market its goods in China. Henhao claimed to be one of China's leading pharmaceutical companies.

Santé, with the help of a professional service provider, investigated Henhao's claims by researching its administration, finances, and operations, as well as its general reputation. Santé took the following steps:

- Primary research: direct contact and interviews with Henhao stakeholders (see chapter 4).
- Secondary research: company documents, media reports, government documents and regulations, company websites and industry reports (see chapters 2 and 3).

Through this examination, Santé amassed a wealth of information about Henhao. Santé learned:

- Henhao's business licence was valid and the company's address, business scope and legal representative were consistent. Santé had previously met Henhao's legal representative.
- Henhao's stated revenues were probably 30% higher than reality: a review of both local media publications and a check with the local AIC showed clear discrepancies.
- Henhao's production capacity was overstated by about three times: an undercover guest, familiar with the pharmaceutical industry, visited the factory. He noticed that much of the machinery was not in use and the factory was understaffed. Undisclosed conversations with Henhao employees also confirmed capacity was smaller than stated.
- Many employees did not have labour contracts and frequently worked overtime. However, they were complimentary about the leadership team and felt the company was successful. They also applauded the company for building a school for the staff's children and for paying salaries promptly.
- All members of the board were well connected within the local community and had received numerous awards.
- China's national pharmaceutical industry association felt Henhao was not a significant player in the market and garnered attention only because of its eccentric CEO.
- Henhao's products were extensively available in provincial hospitals and pharmacies in Hubei. However, its pharmaceuticals were not available in some of the major hospitals in Beijing and Shanghai.
- Henhao had only one environmental compliance violation in the last 5 years.
- Henhao had a 20-year lease on its property, expiring in 2022.

After thorough investigation, Santé concluded that Henhao was a legitimate business with good local success, despite questionable practices and claims. Santé was impressed with the ambition of the CEO, his local connections, and Henhao's commercial prospects. Santé decided not to pursue a JV with Henhao immediately but signed a distribution agreement with the company for regional sales in China.

6. Frequent Scams and Mistakes

Scams are not unique to China, but its distance from your home country, the impenetrable language and vastly different culture combine to make even the shrewdest businessperson apt to lose money through fraud.

The main scam warning signs are:

- An unsolicited request.
- Goods being sold far below market value.
- Payment into an unknown bank account/not in the name of the partner company.
- Payment of facilitation fees, unknown taxes, gifts and so on.
- Full upfront payment.

On the following pages, we introduce a number of common scams that businesses have faced.

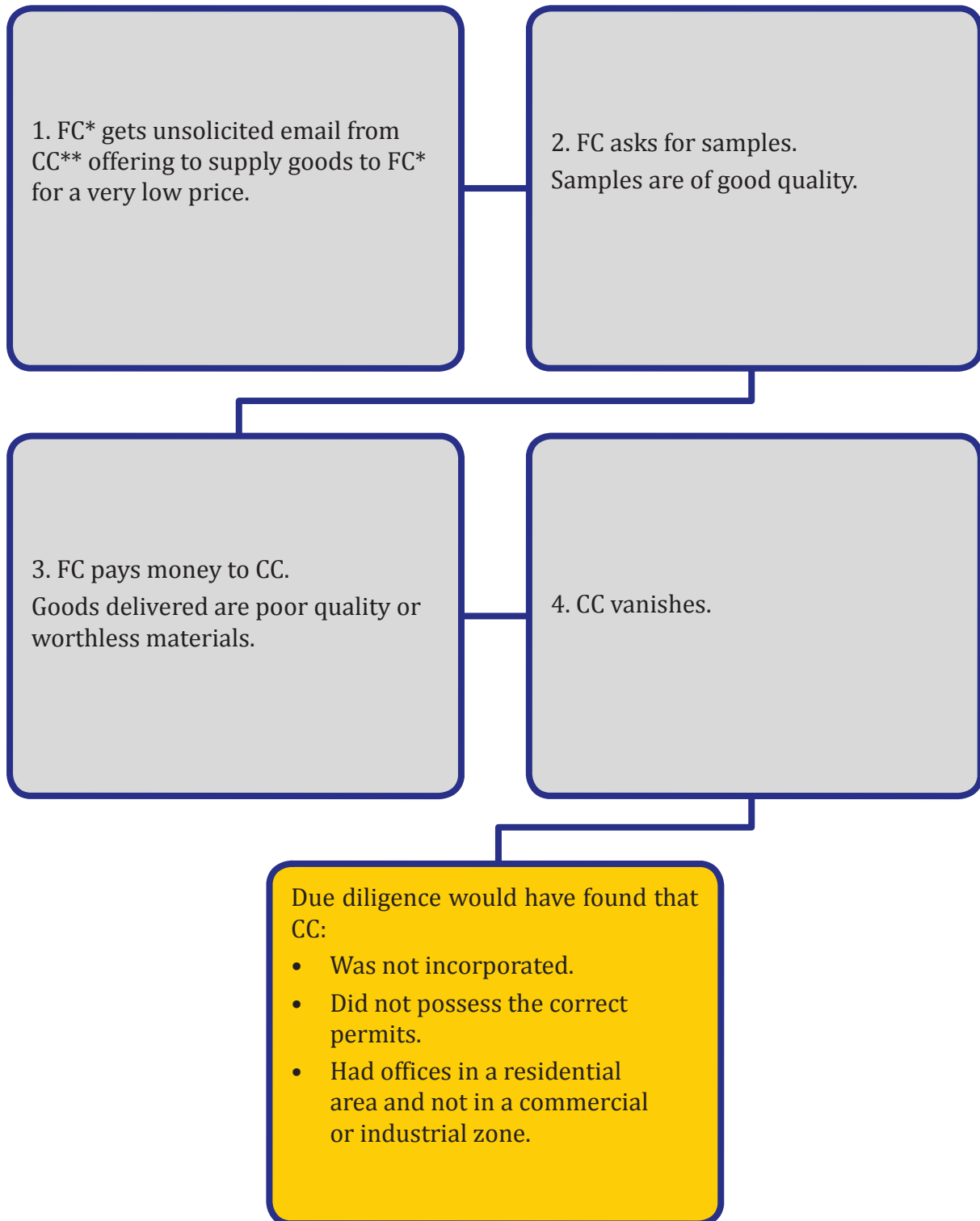
Once you have been scammed, there is often little to be done. Your counterparty knows from the outset that you will try to come after them, so they are careful to cover their tracks and make it impossible for you to take any recourse against them.

The best place to **report a scam** is often the Public Security Bureau where the other party is located. Or, if the company does not exist, the bank branch where their account was registered. However, do not expect active investigation from local authorities. Since some embassies and consulates keep lists of fraudulent Chinese companies, reporting a scam to your country's delegation in China may be a possibility.

It is different, of course, if there is a **genuine business dispute** or sudden non-payment by a regular customer. In such case, your partner probably had no premeditated intention to default under the contract and then vanish, so recourse is often possible.

It is important to act swiftly and with determination because your partner may try to disappear. In some cases, Chinese lawyers may help you **freeze bank accounts** or other assets. This will put pressure on the other side to settle the dispute. In any event, you can be sure there will be recourse once there is a court ruling in your favour.

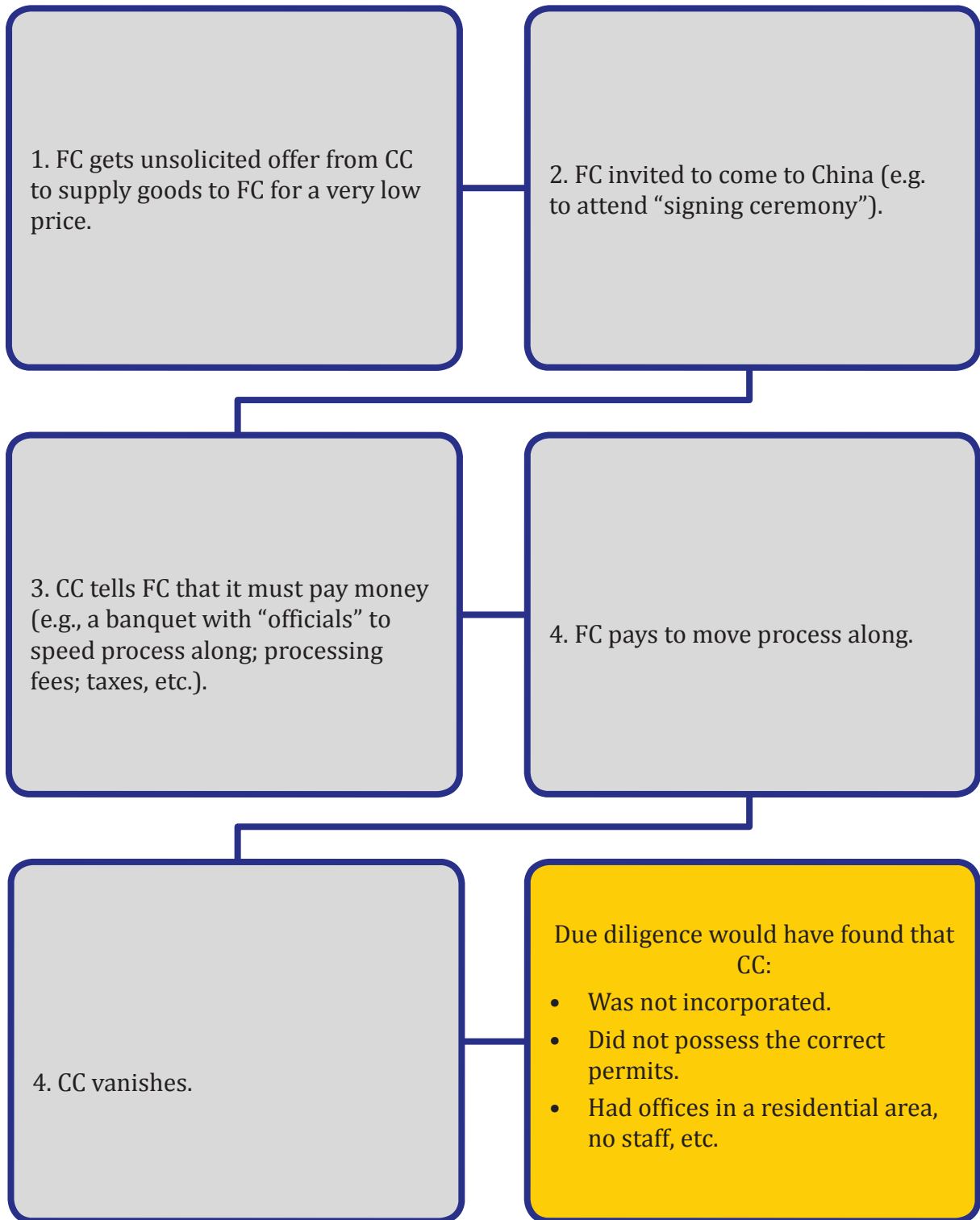
6.1. The Imposter



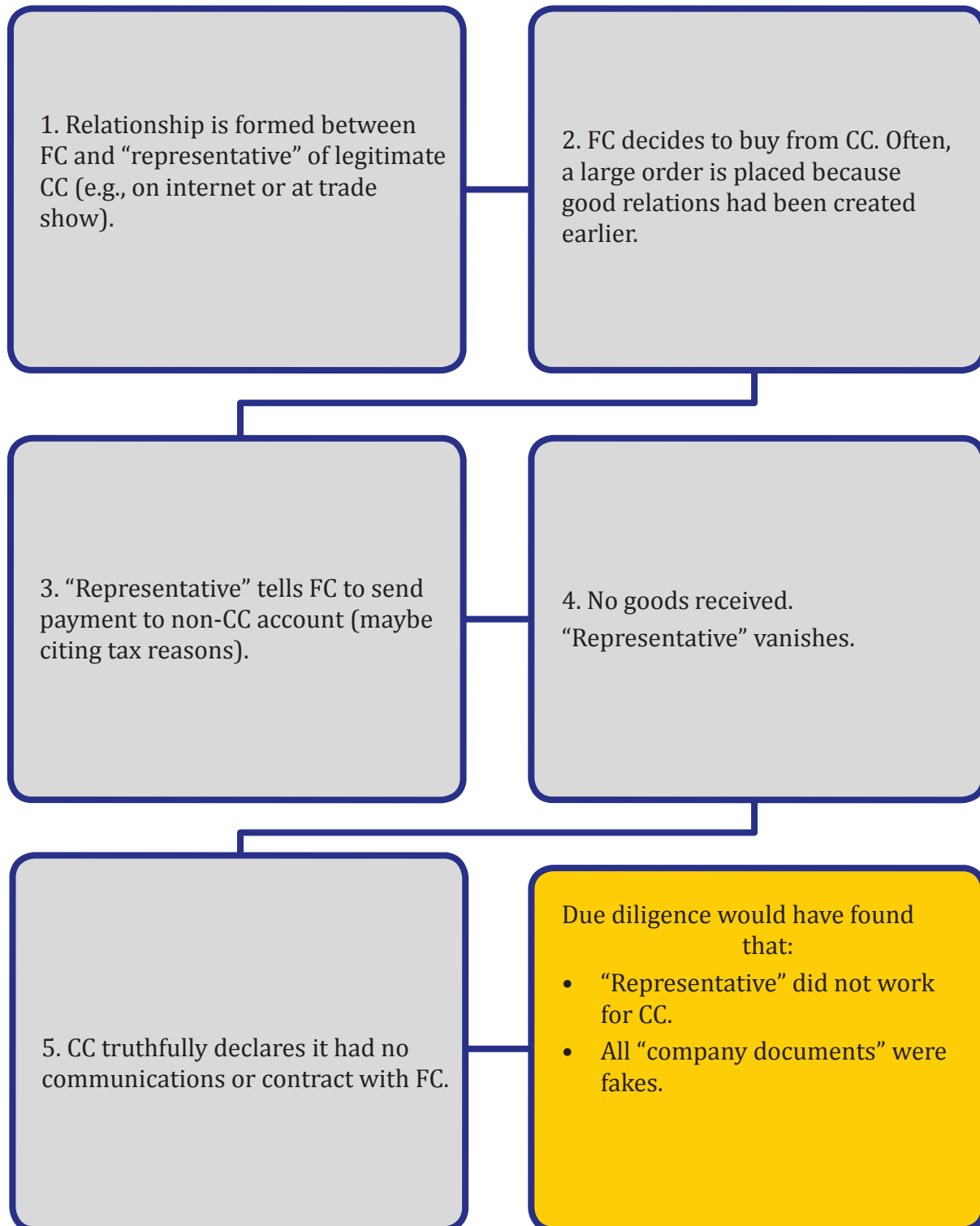
*FC: Foreign company

**CC: Chinese company

6.2. The Fixer



6.3. The Bank Account



A Common Variant: a regular contact at an existing supplier sends an email asking for payment to another account. The timing of this request does not surprise (there is indeed a payment to be made), nor does the tone and content of the email. The amount is paid, but the supplier later claims never to have received the amount. It turns out the employee has gone rogue or the email was hacked. Due diligence would have found that the new account was not registered in the name of the supplier and authorisation to change the account was missing.

7. Due Diligence Best Practices

Not Everything Might Be as It Seems

- Assumptions can put your business at risk.
- At the very least, due diligence can expose information that will help in negotiations and strategy.

Post-due Diligence

- It is recommended that you conduct due diligence throughout your time in China.
- Maintain ongoing due diligence as a natural instinct within your business: today's honest partner may be tomorrow's lawsuit.

Unprofessional Website and Email

- Chinese business people and even government officials sometimes use public domain emails (e.g. sina.com, 163.com) rather than a company email address.
- This is not an immediate deal breaker, but it is worth gaining deeper insight.
- An English-only website is also a warning.

Pay Now, be Secure Later

- The complexity of the China market and labyrinthine nature of information-gathering means that paying a professional service provider to conduct due diligence is a small but highly sensible cost compared to the potential losses of not doing so.

Quality Control and Quality Assurance

- Are the premises close to suppliers, warehouses, distributors?
- Is it near a port, logistics infrastructure?
- Utility quotas on electricity may affect production.

8. Public Authorities

There are several public authorities outlined in this report that can assist in your due diligence research.

Below is a short introduction to the main organisations listed in this report and additional bodies that are a good source of information:

State Administration of Industry and Commerce (SAIC)

SAIC was a central-level government body responsible for brand protection, enforcing anti-monopoly competition affairs and for general administrative affairs, including company registration (including foreign invested enterprises [FIEs]) and issuance of business names and licences. The **Bureau for Registration of Foreign-Invested Enterprises** (国家工商总局外商投资企业注册局) drafts measures for FIE registration procedures and processes the registration of foreign-invested enterprises and representative offices of foreign companies.

According to the State Council's Institutional Restructuring Plan disclosed in the 13th National People's Congress on March 13, 2018, State Administration for Industry & Commerce (SAIC) has been incorporated into the newly established State Administration of Market Regulation together with former China Food and Drug Administration, and General Administration of Quality Supervision, Inspection and Quarantine. As the existing supervision systems of relevant authorities still apply after the institutional restructuring, until new measures are adopted in the future, in this report we will continue to use the former name of the authority i.e. SAIC.

Ministry of Commerce (MOFCOM)

MOFCOM (中华人民共和国商务部) is a centrally administered ministry overseeing domestic and foreign trade, regulating and promoting foreign investment and utilisation, and supporting Chinese companies that expand overseas. It examines and approves foreign investment activities in China and develops trade policies; administers import/export licences; sets quota systems; and formulates foreign investment catalogues and catalogues for imported/exported products and technologies.

China Council for the Promotion of International Trade (CCPIT)

CCPIT (中国国际贸易促进委员会) aims to operate and promote foreign trade, use foreign investment, introduce advanced foreign technologies, conduct activities of Sino-foreign economic and technological cooperation in various forms, promote the development of economic and trade relations between China and other countries and regions around the world and promote the mutual understanding and friendship between China and peoples and economic and trade circles of all nations around the world, in line with law and government policies of the People's Republic of China.

Member State Embassy

Each member state offers a variety of commercial services to companies from its country. Companies are advised to inform their embassy's commercial section in its respected country.

Delegation of the European Union to China

The delegation is responsible for the conduct of official relations between China and the European Union. In all matters pertaining to the European Union, the delegation works closely with the diplomatic missions of the EU member states. It does not, however, deal with trade promotion, consular matters or other issues that have traditionally been handled by the member state embassies, consulates or national tourism offices. The delegation keeps the European Commission abreast of significant political, economic and other developments in China.

9. Appendices

9.1. China Due Diligence Checklist

Administrative and legal standing (chapter 2)

- Check the **online SAIC registration** (chapter 2.1.1)
 - Company name
 - Unified social credit code
 - Company address
 - Legal representative
 - Registered capital
 - Term of business/date of establishment
 - Form of incorporation
 - Business scope
 - Shareholders
 - Management team
 - Company status
- Check the duplicate **business licence** (chapter 2.1.2)
 - Company name
 - Unified social credit code
 - Company address
 - Legal representative
 - Registered capital
 - Form of incorporation
 - Business scope
 - Term of business/date of establishment
 - Find and verify official AIC stamp
- Confirm validity of **company stamp** (chapter 2.2)
 - Visit Public Security Bureau and AIC where company is located
 - Ask whether stamp is registered
 - Inspect various documents filed with local authorities
 - Is stamp used on all documents?
- Confirm authorised use of company stamp (chapter 2.2.2)
 - Visit company HQ
 - Is person who stamped the document employed by the company?
 - Is that employee authorised to undertake that particular business?
- Research the company at AIC (chapter 2.2.4) Hire a Chinese lawyer

- ❑ Lawyer visits AIC office
- ❑ Review company file and make copies at AIC office
- ❑ Confirm company possesses all required permits and licences (chapter 2.3)
- ❑ Confirm company has satisfactory property ownership and land usage rights (chapter 2.4)
 - ❑ Lease contract
 - ❑ Property purchase contract
 - ❑ Ownership certificate
 - ❑ Certificate of right to use
- ❑ Confirm nature of company's intellectual property rights (chapter 2.5)

Financial status (chapter 3)

- ❑ Creditworthiness letter (bank reference letter)
- ❑ Audit reports
- ❑ Financial statement
- ❑ Credit history
- ❑ Capital verification report (if the company is established before March 2014)

Operational status (chapter 4)

- ❑ Visit company's premises (chapter 4.1.1)
 - ❑ Organisation
 - ❑ Quality control
 - ❑ Cleanliness
 - ❑ Employee conditions
 - ❑ Machinery
 - ❑ Location
- ❑ Talk to stakeholders (chapter 4.1.2)
 - ❑ Employees
 - ❑ Neighbours
 - ❑ Competitors
 - ❑ Suppliers
- ❑ Check company's organisational structure (chapter 4.2)
 - ❑ All investors and shareholders mandated
 - ❑ External structure
 - ❑ Internal structure
 - ❑ Company manuals, rules and policies
 - ❑ Details of all meetings
 - ❑ Constitutional documents

9.2. Sample Questions from the Online Quiz *Gauging Your Readiness*

The online quiz *Gauging Your Readiness* accompanies the four reports of the EU SME Centre's Starter Kit. It will help you gauge your knowledge of the Chinese business environment. Here are some sample questions:

- Do you have any evidence that there is a growing demand for your product in China?
- How much do you know about your competitors in China?
- Do you know in which cities you should be selling your product?
- Do you know which distribution channels to use?
- Do you know your customers?
- Have you confirmed that your product can be sold in China?
- Do you know how to find the legal/technical requirements for your product?
- Have you already decided what would be the best way to access the Chinese market?
- How much are you ready to invest upfront?
- Do you understand the various legal structures in China?
- What do you know about the availability of your required human resources in China?
- Have you found a Chinese partner to distribute your products?
- Do you know how to perform preliminary due diligence in China?
- What are your expectations in terms of time to achieve your goals?
- Do you have previous experience in accessing other markets?
- What is your strategy to protect your intellectual property in China?

To find out more about the online quiz *Gauging Your Readiness*, please go to

www.eusmecentre.org.cn/quiz



The EU SME Centre in Beijing provides a comprehensive range of hands-on support services to European small and medium-sized enterprises (SMEs), getting them ready to do business in China.

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