ENVIRONMENTAL PROTECTION AND LABOR SAFETY IN CHINA: THE REGULATORY FRAMEWORK AND APPROACHES TO DUE DILIGENCE

Richard A. Steinwurtzel, Liang Tsui, Andrew J. Green, Jayne Kong, Richard M. Schwartz, and Donna Mussio
Fried Frank Harris, Shriver & Jacobson LLP

The algae blooms on Lake Taihu in 2007 that cut off drinking water for several of China's wealthiest cities and the many explosions and collapses at China's coal mines are symbolic of the challenges that the People's Republic of China (PRC) faces in environmental protection and labor safety, respectively. For nearly thirty years, economic development has been the top priority of China's leaders, but faced with environmental, labor, and other social welfare concerns, the PRC leadership in the last few years has adopted as its goal the building of a "harmonious society"—which means bringing improvements to environmental and labor protections and social welfare without unduly compromising economic growth. The new Labor Contract Law (effective in January 2008) and the elevation of the State Environmental Protection Administration (SEPA) to ministry status as the Ministry of Environmental Protection (MEP) in March 2008 both show Beijing's seriousness with respect to its "harmonious society" policy. Most recently, Beijing's massive measures to improve the air quality of Beijing during the 2008 Olympics, including closing certain polluting factories, severely restricting vehicular traffic, and suspending construction projects, amply demonstrate the scale and speed at which Beijing is able to act.

Decentralization, local interests, and other facts on the ground will continue to shape implementation, but the clear trend is towards greater protection for the environment and labor safety (as well as other labor protections). They are therefore areas foreign interested parties should carefully consider when making a new investment or evaluating ongoing China operations. To assist in that regard, this article sets out the regulatory framework and approaches to due diligence for environmental and labor safety law in the PRC.

REGULATORY FRAMEWORK

Over the last thirty years, China has put in place the laws and regulations necessary to govern a modern economy. Of late, laws and regulations governing environmental protection and labor safety have become increasingly complex. Greater sophistication is also evident in disclosure regimes applicable to publicly-listed companies, including financial statement disclosure. Set out below are key areas of regulation and required disclosure applicable nationally. Localities, particularly Beijing, Shanghai, and Guangdong, may have additional regulatory requirements in these areas.

Environmental Law

Pollution Standards and Permits

The principal means through which the PRC government regulates environmental protection is through a series of standards and permit regimes. The Environmental Protection Law, the Air Pollution Prevention Law, the Water Pollution Prevention Law, the Marine Environmental Prevention Law, the Noise Pollution Prevention Law, and the Solid Waste Prevention Law operate together to set air, water, soil and noise pollution standards as well as to require permits for companies that generate or emit pollutants. National standards are set by the central government, while the issuance of permits generally occurs at the local level. Local governments may require stricter standards than national standards but may not allow lesser standards. Enforcement may be initiated by the local or national authorities.

A company that seeks to discharge or emit regulated pollutants is required to register with MEP. The company is obligated to disclose which pollutants it seeks to emit under normal operating conditions, the facilities it will use to treat pollution, and associated technical data concerning the prevention and control of such pollution. If the discharge is made within the relevant standard, a pollution tariff is applicable to any air or water discharge (not solid waste).

MEP is empowered to enforce the standards and permit regimes through warnings, fines, orders to

suspend operations, orders to install (or use) pollutant treatment facilities, or even orders to close the business of a violator. A company may also be held civilly liable in private court actions for injuries caused by its pollution. If a violation causes a serious environmental accident, the responsible person may face criminal charges. As evidenced by the seventeen indictments (three of which led to life imprisonment terms) arising from the Shan Xi Hong Dong mine explosion which involved 105 deaths, enforcement, including criminal enforcement, is on the rise.

Environmental Impact Reports

The principal other means through which the PRC government seeks to limit environmental harm is through a requirement under the Environmental Protection Law and the Environmental Impact Valuation Law that an environmental impact report be prepared for and approved by relevant levels of MEP prior to certain construction projects. Typically, the approval is granted by the local offices of MEP, though multi-provincial, military, and certain other projects are handled solely within the national MEP office. A developer is required to produce an environmental impact report, an environmental impact form, or an environmental statement depending on the significance of environmental impact. A detailed report is required to be prepared and approved if the project is likely to have a "significant impact on the environment." In these cases, consultation with affected businesses and the public through a hearing or other forums is also required, and the report should include suggestions from the public consultation process that were adopted as well as those that were not adopted and an accompanying explanation. If the project is likely to have only a "minor impact on the environment," a brief statement to that effect is satisfactory.

Clean Production and Recycling

Several new regulations have increased control of which materials can go into certain products and how those products are handled once their useful lives have passed. These regulations supplement product standards already in effect under the Product Quality Law and relevant regulations. In particular, the Clean Production Development Law provides certain guidelines for clean production, including requirements that manufacturers use environmentally sound raw materials and equipment, and collect and recycle waste.

A draft Recycling Economy Law is presently under consideration in the National People's Congress, the principles of which are the reduction of pollutants and the reuse of materials. The proposed legislation aims to use economic incentives as well as administrative techniques to achieve its goal, and tax and financial benefits are provided to companies that meet certain guidelines. In addition, regulations already mandate the reduction and recycling of components in several industries, including the electrical and electronic products and automobile industries.

Pollution Liability

The PRC government is in the trial stage of implementing a program mandating that companies in the chemical, dangerous waste disposal, and certain other industries carry liability insurance for damage to third parties as a result of an environmental accident. In addition, policy makers reportedly are discussing the adoption of a pollution liability regime modeled on the U.S. "Superfund" program.

Green Initiatives

The central government has begun to make environmental compliance relevant to the receipt of several other regulatory benefits.

Environmental review for public companies. As of 2008, the China Securities Regulatory Commission (CSRC) requires PRC companies that are or seek to be listed in the PRC (and, possibly, overseas) and that are in designated heavily polluting industries to provide the CSRC with a report from MEP on the company's environmental compliance record. The CSRC will take into account the MEP report when considering whether to grant listing or other requisite approvals.

Environmental review for bank loans. In 2007, SEPA, the People's Bank of China, and the China Banking

Regulatory Commission (CBRC) jointly promulgated a directive making bank credit contingent on environmental compliance. Under the directive, banks are encouraged to set policies making credit available only to companies that are in compliance with environmental regulations. SEPA and CBRC established an information sharing platform allowing banks more accurately to evaluate companies seeking credit.

Environmental tax and customs policies. In 2007, PRC tax and customs authorities adjusted certain tax and customs policies with an eye towards improved environmental protection. The authorities increased the export tax on products from certain heavily polluting and "high energy consumption" sectors, and a tax rebate given to exporters was eliminated for many heavily polluting or high energy consumption sectors. In addition, the resource tax on various ores used in heavily polluting or high energy consumption industries was increased. Further adjustments of this nature are expected.

Climate Change Initiatives

China participates in the United Nations Framework Convention on Climate Change and, as a developing country, is a signatory to the Kyoto Protocol. Under these agreements, developed countries can buy Certified Emission Reduction credits from developing countries, which credits are derived from Clean Development Mechanism (CDM) projects. China's CDM program is regulated by the National Development and Reform Commission. China has no reduction commitment under the Kyoto Protocol. China, however, is required to formulate cost-effective national and regional programs under the Kyoto Protocol to improve the quality of local emission factors, activity data, and/or models. China, in addition, is obligated to formulate, implement, publish, and regularly update national and regional programs containing measures to mitigate climate change and measures to facilitate adequate adaptation to climate change.

Separately, in 2007, the national government issued a National Plan for Responding to Climate Change, which sets out general policy priorities for the control and decrease of carbon pollutants and adaptation to climate change. The issue of climate change is expected to be the focus of continued regulatory interest.

China's RoHS

In 2006, MEP and five other PRC government agencies approved the Electronic Product Pollution Control Directive (EPPCD), which requires a manufacturer to eliminate or restrict hazardous materials from its products. EPPCD applies to electronic information products, which cover electronic radars, semiconductor, broadcast and TV products, computers, consumer electronics, electrical testing equipment, electrical components, small electronic appliances, and electrical materials. The manufacturer is required to eliminate or restrict hazardous materials in its business operations in accordance with the EPPCD's hazardous materials control standard, and mark and disclose the presence of certain hazardous substances on a product's packaging or specification of a product's contents. In addition, under EPPCD, a distributor is prohibited from selling electronic products in violation of the EPPCD's hazardous materials control standard.

Labor Safety Law

Production Safety Standards and Permits

The Production Safety Law implements a series of standards and permits relating to production safety. Companies are required to implement general standards as well as industry-specific standards and are required to undertake various production safety measures, including the installation of prominent warning signs on dangerous sites, facilities, and equipment. Companies in the construction, mining, dangerous chemical, and certain other industries are also required to obtain production safety permits from the State Administration of Work Safety before commencing operations. The law, moreover, establishes employer liability for production safety violations.

Labor Contracts

An important recent development in labor safety is the requirement under the new Labor Contract Law, in effect since January 2008, that an employer and employee must sign a labor contract that includes disclosures regarding, among other things, the scope of work to be performed, working conditions, the place of work, occupational hazards, and work safety measures. The Labor Contract Law, in addition, prohibits an employer from terminating an employee's labor contract in two circumstances connected to work injury: (i) if the employee was engaged in operations that exposed him or her to an occupational disease or hazard and had not undergone a pre-departure occupational health examination; (ii) if the employee is suspected of having contracted an occupational illness and is being diagnosed or undergoing medical observation.

If the employee contracts an occupational illness or sustains a work-related injury and has lost all or part of the capacity to work, the employee's disability must be verified by the Labor Capability Verification Committee as a condition precedent to the receipt of disability compensation. After the employee's illness or injury is verified at one or more prescribed levels, the employee is entitled to disability compensation on a lump sum basis from the work injury insurance fund (part of social security system) and the employer is required to pay the social security insurance for the employee whether or not the employee works. The employee also will be entitled to receive monthly compensation either from the work injury insurance fund or from the employer depending on the level of disability.

An employer can be subject to administrative penalties as well as civil and criminal liability for labor law violations. For a civil dispute, including a dispute over a labor contract, the parties are required to take the matter to the relevant labor bureau for mediation or arbitration. The bureau's decision may be appealed to a court of law.

Occupational Injury Prevention

Under the Occupational Disease Prevention Regulation, if a new project to be constructed is likely to be one where a risk of occupational injury is present, an occupational injury risk assessment report is required to be submitted to the local health bureau for approval before construction begins. The regulation also requires an employer to disclose occupational injury risks to employees and provide training and physical checkups to minimize the risk and effect of incurring occupational injuries.

Occupational Injury Compensation

The Occupational Injury Insurance Regulation requires an employer to purchase occupational injury insurance for its employees. If an employer fails to provide insurance, and if an employee is injured on the job, the employee can recover against the employer in tort.

Disclosure under the Hong Kong Stock Exchange (HKSE) Listing Rules

While the HKSE listing rules generally do not make specific reference to required disclosures for environmental or labor safety in an initial public offering (natural resources exploration and production companies excepted), the overarching rule requiring disclosure of material information in the prospectus will cover material environmental and labor safety information. The HKSE seeks to ensure that sufficient material information regarding environmental protection and labor safety is disclosed, including, among other things, descriptions of the rules and regulations applicable to the company, any incidents of noncompliance, the attainment of requisite permits and approvals, specific measures taken to comply with the relevant rules and regulations, and any potential future risks with regards to these areas. Furthermore, for post-listing compliance, listed issuers are encouraged to disclose in the management discussion and analysis sections of their interim and annual reports information on the listed issuer's environmental policies and performance, including ongoing compliance with relevant laws and regulations.

Financial Statement Disclosure

Complete and accurate financial statement disclosure forms an important part of environmental and labor safety disclosure. The most commonly encountered issue is when and how to disclose contingent liabilities. Hong Kong Accounting Standard 37, International Accounting Standard 37, and PRC Accounting Standard 13 each adopt a similar standard with regard to an issuer's obligation to make financial statement provision for, and to disclose, contingent liabilities. Under these standards, a provision is recognized when (i) an entity has a present obligation as a result of a past event, (ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and (iii) a reliable estimate can be made of the amount of the obligation. An outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. The measurement used is the best estimate of the expenditure required to settle the present obligation at the balance sheet date—that is, the amount that it would rationally pay to settle the obligation or transfer it to a third party at that time. Contingent liabilities, which are not yet recognized as liabilities on a balance sheet, are to be disclosed in the notes to the financial statements unless the possibility of an outflow of resources embodying economic benefits is "remote" (an undefined term under the applicable International Accounting Standard that requires the application of a materiality concept).

ENVIRONMENTAL AND LABOR SAFETY DUE DILIGENCE

The expansion of the PRC regulatory framework for environmental protection and labor safety means that heightened consideration should be given to these issues when investing in China. The principal means for a foreign investor to evaluate the environmental and labor safety record of any investment target is the due diligence process. Due diligence, properly done, will identify potential problems and, in combination with legal and in some circumstances further technical analyses, allow an investor to make an informed decision regarding whether and how to invest. Set out below are some practical steps that should be taken as a part of the due diligence process, followed by several sample due diligence information requests.

General Due Diligence Steps

1. Tailor the Approach to Fit the Nature of the Transaction

Every transaction is different, and the due diligence approach depends on many factors. The most obvious factor is the nature of business of the company that is being reviewed. This factor will determine the questions to be asked, the depth of the review, and the extent of necessary follow-on legal and technical analyses. Naturally, greater attention should be paid to environmental compliance for companies heavily involved in the use or generation of hazardous materials. Those companies involved in hazardous methods of production, moreover, require greater labor safety due diligence.

The type of transaction itself may also affect the due diligence approach. With respect to securities offerings, the approach to due diligence must be designed to ensure compliance with all applicable securities disclosure requirements. Merger and acquisition transactions or private equity investing are different, and the due diligence needed will depend on the information that the acquirer or investor requires to make a decision, balanced by the time and cost the acquirer or investor is willing to incur and the degree of risk the acquirer or investor is willing to accept. The 100 percent acquisition of a company by a listed acquirer could require a different diligence approach than a small minority investment by a private party. In sum, due diligence should be carefully planned.

2. Request and Review Documentary Information

A due diligence information request list should contain both general and tailored requests. Attention should be paid to the varying regulatory requirements applicable to different industries and different locations. As companies may themselves not entirely understand their regulatory obligations, it often falls to the advisers

to inform them of what is required. In all cases, certain basic information will need to be reviewed, such as permits and approvals necessary to operate. Several sample information requests are set out below. In particular, the following should be obtained:

- Environmental and labor safety licenses, permits and approvals, including land use rights certificates, pollutant discharge permits, production safety permits, and construction permits;
- Environmental impact reports and occupational injury risk assessment reports (and related approvals), environmental and labor safety audit reports, and environmental site assessments (including the results of any sampling);
- Labor contracts, material contracts relating to environmental and labor safety matters, and merger and acquisition agreements;
- Environmental and labor safety insurance policies; and
- Claims, notices of violations, and administrative penalties for environmental and labor safety matters.

In addition, audited financial statements and the related footnotes, if available, need to be closely reviewed from the environmental perspective.

3. Conduct On-site Visits and Telephone or In-person Interviews

Documentary review is only one part of the due diligence process. On-site visits and in-person and telephonic interviews are essential to understanding a company's operations, particularly from an environmental and labor safety compliance perspective. Direct personal experience at a company can be helpful in evaluating how seriously the company takes environmental and labor safety compliance. Interviews can bring out points of concern not otherwise evident and highlight areas where further documentary review and legal or technical analysis may be necessary. On-site visits should be made of the company's principal operating sites, and interviews should be conducted with the following persons:

- Senior management responsible for environmental and labor safety matters, including the director of human resources and in-house counsel;
- The chief financial officer and, in some cases, the company's outside accountants (with respect to contingent liability issues);
- Managers at specific facilities and their lead environmental and labor safety compliance officers (depending on the depth of the review);
- Outside counsel (for any potentially material environmental and labor safety legal proceedings); and
- Outside consultants (for any potentially material environmental and labor safety investigations/remedies).

4. Retain Expert Consultants to Conduct Site Assessments, If Necessary

Parties generally do not retain separate expert consultants to review environmental or labor safety compliance. In some cases, however, where complicated technical issues are present or where environmental or labor safety compliance is of particular importance, such as the acquisition of a company in an environmentally sensitive business, seeking outside expert analysis is prudent.

5. Obtain a PRC Legal Opinion

A PRC legal opinion forms an important part of the due diligence record of both stock offerings and merger and acquisition or private equity investment transactions involving a PRC business. For Hong Kong listings, the HKSE requires a PRC legal opinion covering the proposed issuer's compliance with all applicable PRC laws and regulations, including environmental protection and labor safety laws and regulations. As the opinion is required by the HKSE to list out, among other things, the details of the licenses, permits, or certificates obtained by the issuer, the PRC legal opinion generally takes a form similar to that of a due diligence report rather than to that of a customary securities opinion. For U.S. or U.K. listings, a PRC legal opinion, in a more customary securities opinion form, is a useful part of the due diligence record. For merger and acquisition transactions or private equity investments, the acquirer or investor may request the

company to procure a PRC legal opinion with respect to the legality and enforcement of agreements in the PRC and with respect to compliance with the law in the PRC.

6. Consult with Government Authorities in Special Cases

In certain industries where environmental or labor safety problems have been especially prominent, seeking guidance and understanding from relevant government authorities may be prudent prior to proceeding with a transaction.

7. Continue Due Diligence throughout the Transaction

Due diligence is a process that continues from the beginning of a transaction to its completion. It is important to keep track of documents that have yet to be provided and follow-up at appropriate times. "Bring-down" due diligence interviews should occur at various stages of a transaction to ensure that no adverse material change has suddenly occurred or developed. For some transactions, an acquirer or investor will obtain a due diligence report. From time to time, an acquirer or investor may propose, at one or more interim stages, to move forward without complete information. In those cases, careful evaluation should be made of the risks involved and the benefit that additional due diligence steps will provide. In the acquisition context, careful contract negotiations over representations and warranties (and related disclosure schedules) serve as an excellent due diligence mechanism. For example, a comprehensive set of environmental representations will often require a seller to provide correspondingly detailed disclosure schedules. Sellers often delay, or fail to provide, such disclosure schedules until the late stages of a transaction, and such schedules must be reviewed carefully to ensure that no new issues are being disclosed for the first time.

Information Requests for Due Diligence

Presented below are sample requests that target information which is helpful in understanding the environmental and labor safety condition of a PRC company.

Properties

Sample Request: Please identify and describe all real property or other facilities owned, operated or leased, either directly or indirectly (*i.e.*, through subsidiaries, joint ventures, operating units, or other related entities) and provide all relevant land use rights certificates, building ownership certificates, and construction permits.

Environmental and Labor Safety Management

Sample Request: Please identify and describe (i) individuals currently responsible for environmental and labor safety compliance; (ii) environmental and labor safety compliance programs and practices; and (iii) current pollution prevention, control, or countermeasure plans and emergency response plans. Indicate whether any facilities have achieved ISO 14001 certification.

Environmental and Labor Safety Permits

Sample Request: Please provide copies of all environmental and labor safety permits, waivers, exemptions, exclusions, variances, warnings, notices of violation, fines, communications with regulatory authorities regarding compliance with any such environmental or labor safety permits, and any proposed or pending applications for issuance or renewal of any environmental and labor safety permits.

Environmental and Labor Safety Reports, Audits, and Inspections

Sample Request: Please provide copies of (i) all environmental impact reports and occupational injury risk assessment reports and related government approvals; (ii) all other environmental and labor safety audits, action plans, reports, impact statements, tests, site investigations or assessments, whether performed internally or by an outside consultant; (iii) reports or other documents relating to any inspection by any

governmental entity concerning compliance with environmental and labor safety laws, regulations, and permits; (iv) material safety data sheets and studies concerning health effects upon employees in connection with occupational exposure to any substances; and (v) notices or filings pursuant to any environmental and labor safety laws, regulations, and permits. In addition, to the extent known, identify any conditions or events that might give rise to environmental or labor safety liabilities.

Claims, Information Requests, and Notices of Violation

Sample Request: Please provide copies of all administrative or judicial orders, injunctions, notices, records of decision, claims, complaints or correspondence discussing actual or potential liabilities, requests for information, citations or notices of violation relating in any way to environmental or labor safety matters (including claims for cleanup costs, fines or penalties, property damage and/or personal injury, and notices of liability or potentially responsible party).

Climate Change

Sample Request: Please provide copies of all studies, capital expenditure plans, and other programs proposed or being considered by or on behalf of the company relating to the impact of climate change on the business, including any calculation of emissions inventories and any calculation of the potential costs (and/or opportunities) associated with reducing greenhouse gas emissions, such as installation of pollution control equipment, operational changes, and the purchase and/or sale of carbon offset credits. If a CDM or other emissions trading programs has been implemented, please provide any applications and government approvals relating thereto.

Labor Contracts

Sample Request: Please also provide (i) copies of labor contracts for each category of employee where labor safety provisions differ, and (ii) a written description or organizational chart delineating the categories of employees engaged in hazardous activities.

Agreements

Sample Request: Please provide copies of any contractual indemnity, allocation, or other cost-sharing provisions relating to environmental or labor safety liabilities, including all such provisions contained in any acquisition, sale or merger agreement, or in any separate letter agreement or other documents.

Audit Letters

Sample Request: Please provide copies of all letters or other documents prepared internally or by any legal counsel or other experts in response to inquiries by any auditors reflecting any information relating in any way to environmental or labor safety matters.

Capital Expenditures and Asset Retirement Obligations (AROs)

Sample Request: Please provide copies of all budgets, proposed capital projects, and other estimates of capital costs and other expenditures for environmental and labor safety matters, including AROs.

Insurance

Sample Request: Please provide copies of all insurance policies and claims, notices or other communications with insurance carriers relating to environmental or labor safety liabilities, including documents relating to occupational injury insurance claims and amounts paid to employees pursuant to such claims or pursuant to other actions alleging personal injury.

Financial Reserves

Sample Request: Please provide information regarding any financial reserves in connection with environmental or labor safety matters, and a complete breakdown of any such reserves.

CHALLENGES GOING FORWARD

The establishment of regulatory regimes governing environmental protection and labor safety in the PRC has proceeded of late at a quickened pace, and all signs point to its continued emphasis by the central

government. The landscape of laws and regulations enacted is increasingly comprehensive, but for the foreseeable future, implementation and enforcement gaps will remain. The elevation of SEPA to ministry status reflects the central government's desire to strengthen environmental protection, and the new Labor Contract Law manifests the central government's desire to provide additional protection to workers.

Notwithstanding the heightened interest in these areas by the central government, local governments continue to manage the local offices of the environment protection and labor bureaus, and one can realistically expect a great degree of decentralization to continue. Given the priority that local governments—for a variety of reasons—generally place on economic growth, local interests are likely to continue to lead to uneven enforcement of environmental and labor safety rules. This fact of life can pose a challenge to an acquirer or investor which seeks to evaluate the target company's compliance with local and national regulations.

Despite these challenges, it is clear that the overall policy direction is towards increased environmental protection and work place safety, as both are key policies underlying the PRC leadership's goal of building a "harmonious society." Accordingly, these areas have become more significant and will likely be subject to additional regulatory focus. Foreign interested parties would be prudent to increase scrutiny of these areas prior to an investment and to maintain continued oversight after the transaction is closed. Thoughtful and substantively thorough due diligence should be the norm, and contractual protection should be emphasized. Opportunities abound in China, but to succeed in the long term, careful planning and capable execution are essential in avoiding costly or crippling environmental or labor safety issues.

Richard A. Steinwurtzel *and* **Liang Tsui** *are partners, and* **Andrew J. Green** *and* **Jayne Kong** *are associates, in Fried Frank Harris, Shriver & Jacobson LLP's Asia offices.* **Richard M. Schwartz** *is a partner, and* **Donna Mussio** *is an associate, in the firm's Environmental Practice Group in New York.*