

## **ENVIRONMENTAL DUE DILIGENCE IN CHINA (Redacted)**

Environmental due diligence, or environmental auditing, is imperative and challenging in China. It is imperative since deviation and violation of environmental laws are so widespread that many (of course not all) enterprises are exposed to environmental risks to certain extent; it is challenging because the gap between the theory and practice of environmental laws are so deep that practitioners and in-house counsels usually find themselves struggling in the midst of literally stringent requirements on pollutant control and actually loose implementation of environmental rules, of literally harsh liability and actually insufficient penalty for violation. Unlike financial soundness and employment management effectiveness the importance of which have been generally recognized in pre-acquisition investigation by most companies, environmental due diligence in China has not yet been paid enough attention in the past. However, as China has strengthening its environmental protection management and supervision, tightening its pollution control and the public are more and more conscious of their environmental rights, practitioners and in-house counsels should know how to identify environmental issues and assess the legal risks in connection therewith.

This chapter is targeted to give practitioners and in-house counsels an introduction about how to conduct environmental due diligence from legal perspective so that they can make initial assessment of the potential risks and decide whether to engage outside environmental auditors. It does not, however, intend to cover the methods and scope of environmental due diligence to be conducted by environmental auditors – especially those involving technical and engineering probes.

This chapter contains four sections. Section 1 describes the typical issues that practitioners and in-house counsels may face in assessment of environmental risks, and our suggestions of coping with these issues. Section 2 introduces different scopes of environmental due diligence in terms of the depth and width, with a brief of the coverage of outside environmental auditing. Practitioners and in-house counsels may understand what they can do and, if necessary, what the environmental auditors can do, in environmental due diligence. Section 3 spells out the key factors practitioners and in-house counsels need to consider in their review of target's environmental documents. By doing so, practitioners and in-house counsels may be able to make initial assessment of the significance of the risks and decide if environment auditing is necessary. Section 4 includes a request checklist for environmental due diligence from legal perspective.

Environmental concerns vary from industry to industry. This chapter does not intend to produce an exhaustive list of all concerns (it is hard to do so – if not impossible – imagine the difference of a nuclear power plant and a thermal power plant, or a highway project and a tint factory). Conversely, it hopes to give a general introduction that may apply to most circumstances (although the content may need to be customized to suit specific demands). For this purpose, we assume the target is a company engaging manufacturing activities.

The purpose for environmental due diligence may be different -- some are for internal review of regulatory compliance; others are for risk assessment of an acquisition deal. Because the pre-deal due diligence is more often and is more comprehensive in depth and width, this chapter will use pre-acquisition due diligence as an example.

### **1. TYPICAL ISSUES OF ENVIRONMENTAL DUE DILIGENCE IN CHINA (1.0)**

The Environmental laws of China are still in the developing stage. The enactment and enforcement of environmental laws are still not so developed compared with developed countries, leaving lots of issues that practitioners and in-house counsels may have never been exposed in other jurisdictions. Tackling these issues requires a pragmatic approach and some local knowledge.

#### **1.1 Diligence In A Developing Environment**

China's enactment of environmental laws can be traced back to the late 1970s, when the policies of reform and open-up were announced at the first time. Over the years, China has developed an legal framework for environmental protection which adopts most of the pollution control measures that have been proved effective in the developed countries, such as requirements of pre-construction environmental impact assessment (EIA), the "Three Concurrence" (*i.e.* the pollutant treatment facility attached to a factory facility should be designed, constructed and put in use concurrently with the factory facility), environmental completion acceptance, report and registration of pollutants discharged, generators liability for cleanup of contaminated site and compensation for the loss of aggrieved parties incurred out thereof, etc. Failure to compliance with these rules will trigger off administrative penalties, civil claims, or even criminal liability in worst cases.

However, this legal framework is far from workable in alleviating the increasingly serious pollution in China. Some provisions of China's environmental laws cannot be followed simply because lack of detailed rules and conditions precedent for implementation. Predicting the legal consequence of an activity which appears to contradict with some general requirements but the implementation of which have yet been initiated is a real challenge to practitioners and in-house counsels. There are no generally recognized ways to make such inevitable but difficult prediction. Our suggestion is, under such circumstances, practitioners and in-house counsels "borrow" the unique method of "filling the gap" of laws that has been widely utilized in lawyer's advocating, *i.e.* in case of lack of direct legal authority, seeking for non-mandatory authority to fill a gap in the environmental laws from the following sources:

- *Legislative background of the general requirements, which may indicate the thoughts of the legislators about the general requirements, and the rationale why the implementing rules are not included underneath the general requirements of the same law;*
- *Draft implementing rules if the codification of which is underway;*
- *Local rules of other provinces and cities on implementing the general requirements of national laws, which may give reference to the subject provinces and cities on the same issues;*
- *Judgements of different level of courts (especially those of the Supreme Court and High Courts), which are non-binding but will be inevitably affect the enforcement of the general requirements;*
- *Positions and approaches of scholars and individual officials, as stated or implied in their books, reputable journals, or at high-profile seminars or conferences; and*
- *Laws and practice of foreign countries or regions on the same issues, especially the United States, Europe Union, Japan, Hong Kong and Taiwan.*

Positions of environmental protection administrations at city and county levels can be a reference, but cannot be fully relied on in environmental due diligence (See Section 1.2 below for the reasons).

## **1.2 Gap Between Theory And Practice**

China's environmental legal framework, despite of the above problems, are essentially congruent with those in developed countries. Generators are required to take effective measures to control pollutant discharging and clean up contaminated sites, in addition to compensate for the loss of injured parties. In theory, therefore, the requirements for construction and operation of factory facilities in China and in developed countries are essentially the same. China's enforcement of its environmental laws is highly capricious, however, leaving practitioners and in-house counsels struggling in the midst of theory and totally different reality.

In July 2007, SEPA launched a broad-ranging investigation into the country's industrial zones and enterprises located at the main river valleys (namely Yangtzi River valley, Yellow River valley, Huaihe River valley and Haihe River valley) of China. The result shows that 110 out of 126 industrial zones being investigated have problems of illegal activities regarding environmental protection, representing 83.7% of which being investigated and 234 out of 529 enterprises inspected were found illegally discharging or over-discharging pollutants, representing 44.2% of which being inspected. The main problems found include: approving the construction of projects without assessment of environmental impacts, approving projects beyond its approval authority, the poor implementation of "Three Concurrence" and discharging pollutant without discharging permit or over-discharging. As this example vividly illustrates, violation of environmental laws is a widespread phenomenon in China, resulting in the pollution more and more serious despite of the constant effort of SEPA (MEP) to curb the problem.

There may be diverse causes of pollution problems in China. While China adopted its first environmental law in the late 1970s, it was until 1996 that most county-level governments started establishment of its independent administration for enforcement of environmental laws, and many of them are suffering from shortage of experienced staff, crucial equipments, necessary technologies and, more importantly, independent power to curb pollutant discharge. The environmental laws of China do vest certain powers to environmental protection administrations to take actions against pollutant generators, such as imposing penalty discharging fee for over-discharge of pollutants and fines for other wrongdoings and ordering the generator to stop illegal acts and get things right within time limit, but lack of powers to suspend generators' production activities or close it down (such powers are vested to local governments, which usually have more incentives to stimulate production than to curb the seemingly remote pollutions) make them unable to take effective measures against increasingly serious pollution problems.

China has created a record of economic growth in the world – sustaining a stunning annual growth rate since 1978. One of the key elements for this success is the introduction of GDP as an important parameter (and probably the most important parameter) to assess the performance of local governments and government officials. Though nowadays, with the development of environmental protection practice in China, local governments pay more attention to the environmental protection and seek for harmonious development of economic growth (including GDP) and environment protection, as GDP is so important to the political careers of government officials, stimulating GDP increase by attracting more and more projects overwhelms other objectives of local governments in the past. The problem is, with the competition of local governments becoming more and more fierce, many of them starts emphasizing not the advantages of their location and infrastructures, but the lowered requirements on pollution control and employee entitlements. The environmental enforcement officials of the local governments, whose political futures and salaries are decided by the top officials of those governments, usually have no choice but turning blind eyes on what's happening. Or even worse, environmental enforcement officials tend to collude with local government and the project developers to circumvent the environment laws – as evidenced by the fact that lots of factory operators ultimately obtain pollutant discharge permits, even though they did not conduct environmental impact process for projects.

Because of the above, practitioners and in-house counsels should be vigilant in reviewing approvals, permits, comfort letters and other documents produced by local environmental protection administrations related to a company's regulatory compliance with environmental laws – some of them may be doubtful. Conversely, practitioners and in-house counsels should seek for a more constructive way of interviewing local enforcement officials by requesting them to clarify certain points that have been identified in reviewing other documents (such as EIA documents) or to confirm the requirements and standards locally applicable to pollutant discharge. Always putting a question mark in your mind in checking the confirmation by the local environmental protection administrations.

### **1.3 Working With Financial And Operating Information**

It is not uncommon that practitioners and in-house counsels find themselves in difficulty in gathering information for environmental due diligence – you may have to ask the construction division of a target for EIA reports, design drawings, and final acceptance documents for both a factory facility and the attached pollutant treatment facility, while persuading the financial manager to produce the ledgers concerning payment of pollutant discharge fees. The pollutant discharge permits and pollutant discharge registration forms may be kept by a staff in charge of public utilities, who messed them with old documents and newspapers stuck in a cabinet. Even you are lucky enough to get access to the files of the local environmental protection administration (which is not easy by the way), you will soon lose your way in the jungle of cabinets, boxes and binders – the files may be categorized chronologically, but not in terms of companies and no index available. It seems everyone you met can tell you something, but you cannot map out a whole picture of how many site and production lines have been built or renewed or expanded in the past, how many of them need to have pollution pre-treatment facilities and whether such pre-treatment facilities have been put in place.

A thorough and comprehensive due diligence (so-called phase II due diligence) can definitely figure out the potential risks, but the time and cost for such a due diligence make it unjustifiable in most cases (for example, if the due diligence is conducted on a data-review basis). Practitioners and in-house counsels need to gather some first-instance information, and then work out a suggestion about the width and depth of environmental due diligence and, the necessity of retaining outside environmental auditors.

So is there a place to get started? The answer is yes. Practitioners and in-house counsels can start the due diligence by analyzing the financial information and operating information of targets. Because targets always tend to boast their financial and operating performance by maximizing the relevant figures as much as possible – the lest likely moment for covering up output. Therefore, if practitioners and in-house counsels encourage the targets to spell out their financial and operation data (e.g. by explaining how many products manufactured and sold in a given year) first, and then have the target bringing down the volumes of products manufactured by each site or each production line, the number of sites and production lines can be figured out – next step would be much easier: tracking down the environmental documents for each site and production line.

Looking into the financial and operating information can also help practitioners and in-house counsels identifying the time and scale of maintenance and renewal works on both factory facilities and pollution treatment facilities, and thus trace the necessity of EIA process for the maintenance and renewal and if so, whether the EIA process has been conducted. By checking the vouchers of payment for pollutant discharge fee, pollution penalties and compensation for injured parties, practitioners and in-house counsels can track down the bases of such expenses and, by doing so, figure out the volume of pollutant discharge of the target and whether the target has been imposed penalties by environmental enforcement authority and whether it has disputes with other parties in respect of environmental issues.

Starting from financial and operating information requires practitioners and in-house counsels have basic financial reporting knowledge – or obtain the help of outside auditors who are auditing the financial statements at the same time.

#### **1.4 Taking China Into Account**

Taking China into account requires: (1) having regard to the uncertainties of potential liability created by the vague languages of China's environmental laws; and (2) having regard to the lower standards of pollutant discharge and lower cost of cleanup in China.

Administrative penalties on violation of environmental laws in China are far from significant – As discussed in Section 1 -- the likelihood for suspension of production activities or being shut down is slim because of local government's reluctance. While pollution is increasingly serious over the past years, only a little amount of them were submitting to the courts – partially because the courts are also politically and

financially controlled by local governments, partially because the high cost of testing contaminated samples and evaluating the loss, partially because the language of the environmental laws is vague -- All these seems to encourage pollution generators and discourage aggrieved parties.

However, practitioners and in-house counsels should bear in mind that most environmental laws of China were enacted in 20<sup>th</sup> century – the time when state owned enterprises (SOEs) were dominant China's economy. While it seems unlikely for China to vastly change its legal framework in the near future, nor to treat foreign invested enterprises unequally compared with SOEs under the WTO Protocol, there is still another concern that the environmental protection administrations and the courts may impose harsher liability on pollutant generators by interpreting the vague language of environmental laws of China.

On the other hand, practitioners and in-house counsels should also bear China in mind while computing correction costs. The discharging and emitting standards are much lower in China than developed countries, and so are the costs of construction and maintenance hazardous waste bury yards. It should be fine that some environmental auditors give reference to the cleanup practice of European Union and the United States and the costs associate therewith, but without regard to China's characteristics often leads to overestimation.

## **2. DIFFERENT SCOPES OF DUE DILIGENCE (2.0)**

So far, few Chinese companies have been conscious of the value of environmental due diligence, and few Chinese environmental engineers have exposure to environmental due diligence works. Due to low demand, China has not developed its rules, standards and best practice over environmental due diligence. Almost all environmental due diligence investigations that came to our knowledge were requested by foreign companies or their Chinese subsidiaries, and almost all such due diligence were conducted by foreign agencies with international reputation.

As there are no applicable rules in China, the foreign agencies introduced those in developed countries – principally the various Standard Practices published by the American Society for Testing and Materials (ASTM)– with a few customization according to the situation of China. Together with these Standard Practices, terms referring to different scopes of due diligence, like "Phase I", "Phase II" have been generally accepted in China.

Before retaining outside environmental auditors to conduct Phase I, practitioners and in-house counsels can preview the situation of the target from the relevant documents and then decide the necessity of physical investigation by outsider.

### **2.1 Document Preview**

The environmental laws of China requires various of documents to be prepared, filed, approved and issued at different stages of construction and operation of industrial sites and production lines, covering most of the environmental issues that may arise on the target's front. Therefore, review of such documents can identify certain environmental issues and assessment of the associated risks – as well as the necessity of physical investigation by the environmental auditors.

Section 3 introduces the key points that practitioners and in-house counsels should pay attention to. Section 4 is a sample checklist of requested documents. By utilizing the tools described in these two sections, practitioners and in-house counsels would be able to frame major environmental concerns of the target.

### **2.2 Phase I Due Diligence**

The objectives of a Phase I environmental site assessment (ESA) are to assess the probability of environmental concerns associated with current use of the site, and adjacent sites, and to determine the requirements for further investigation or remedial action. Typical scope of a Phase I ESA includes:

- *A review of regulatory history and environmental compliance data*
- *Interviews with persons knowledgeable about the site*
- *Evaluation of current and historical site activity*
- *A visual observation of the property and adjacent properties*
- *A determination of the present of known underground storage tanks*

Phase I ESA include inspection of the subject property and review of public records to determine whether there are any recognized environmental conditions (RECs) associated with the property (Examples of RECs are evidence of an underground storage tank or stained soils or stressed vegetation). For properties where circumstances suggested a low risk of any RECs associated with the property, a Phase I Transaction Screen may be appropriate instead of a Phase I ESA. The Transaction Screen is an abbreviated (and usually cheaper) version of the Phase I ESA.

A detailed evaluation of the compiled information prepared into a comprehensive Phase I ESA report that will include the results of the assessment, opinions, conclusions and recommendations.

### **2.3 Phase II Due Diligence**

A Phase II ESA is conducted after the results of a Phase I ESA have indicated on-site or off-site environmental concerns that warrant further investigation.

The objectives of a Phase II ESA are to evaluate and describe site hydrogeological conditions, determine the location, type, and concentrations of contaminants, and determine the requirements for remedial action based on the applicable regulatory environmental guidelines. The Phase II ESA report will give detailed explanations of environmental concerns, specific site characterizations, and remedial solutions.

Under certain circumstances, companies may go further with environmental due diligence, Phase III, Phase IV, and so on. Despite of the different names and scopes defined by different environmental agencies, such further due diligence is generally conducted in conjunction with, and subsequent to, remedial action. Once Phase II assessment activities have documented the contaminants of concern, the appropriate remedial technology is selected based on the data collected. After implementing the remedial action of choice, sample collection, analysis, and documentation become integral aspects of the remedial action until that action has been completed to the satisfaction of the regulatory agencies involved. Following completion of remedial action, a whole report is generated encompassing all phases of due diligence and remedial action data to document that regulatory guidelines have been achieved and “no further action” is required.

### **2.4 Are Environmental Auditors A Must?**

Environmental due diligence involves lots of technical knowledge and engineering experience – similar to financial due diligence that requires accounting and taxation expertise. Even in the simplest Transaction Screen process, understanding the results of the interactions of different chemicals under given temperature and other conditions is a must for investigating an industrial site. Going further, lots of drilling, sampling, testing and sometimes experiment work will be necessary in both quantifying the pollution extent and confirming the cost of solutions. That's why environmental due diligence involves more TECHNICAL

than LEGAL works – which, consequently, should be done by engineers instead of practitioners and in-house counsels – like financial due diligence that has to be conducted by qualified auditors.

However, practitioners and in-house counsels would underestimate their functions if they just stand idle in the process of environmental due diligence in China – there are some LEGAL work that needs to be done:

Firstly, at the document preview stage, practitioners and in-house counsels should review the first batch of documents and decide whether a technical due diligence is necessary and, if the answer is yes, the scope of the technical due diligence. By making such a decision, the practitioners and in-house counsels need to know from the documents whether the target has fully complied with the environmental laws and standards of China.

Secondly, in the process of the technical due diligence, practitioners and in-house counsels should coordinate with the outside auditors in identifying the LEGAL risks of any environmental incompliance – not only the cost of solving a pollution problem, but also the possible administrative, civil or even criminal liability.

Thirdly, practitioner and in-house councils needs to attend the discussion with the target and the local environmental authority if there is a need to isolate the liability of the target from previous owners or operators of the subject site.

### **3. KEY POINTS OF DOCUMENT PREVIEW (3.0)**

Like other similar procedures, environmental due diligence starts with gathering information from the target by using a request checklist.

Working out the number of sites and production lines operated by the target by analyzing its financial and operating information. Compare the result with that provided by the target in response to the checklist and request an explanation.

Figuring out the whole picture of target's operation is the most difficult but imperative task in due diligence in China. But one cannot figure out how many environmental issues the target may have without the whole picture of its operation.

#### **3.1 Review EIA Documents**

As you have learned in this chapter, construction (including renewal and upgrading) of each site or each production line requires environmental impact assessment beforehand. Depending on the extent that the environment is affected, the EIA can be made in the form of EIA Report, EIA Form, or Environmental Impact Registration Sheet (EIRS). The form of EIA Form and EIRS is formulated by MEP and shall be filled in by the competent environmental impact auditor (for EIA Form) or by the project company itself (for EIRS) and the form and contents of EIA Report should be prepared by environmental impact auditors with appropriate qualifications, and be approved by environmental protection administrations with sufficient authorities. By checking the satisfaction of each element, you can tell the legality of an EIA document.

##### **3.1.1 EIA Report, EIA Form Or EIRS**

China categorizes projects into three columns in term of the impacts they may impose on the environment: significant, slight and trivial. Developers (future owners) should retain qualified agencies to conduct comprehensive and thorough assessment to projects that may bring significant impact to the environment, the result of which should be EIA Reports; to projects the environmental impact of which are slight, developers should retain qualified agencies to briefly analyze or specifically assess certain aspects of the

EIA, the result of which should be EIA Form; to those with trivial impact to the environment, developers can simply file EIRS to the competent environmental impact administration.

Once you have figured out how many sites and production lines a target has, the next step is to identify which category of the sites and products lines belong to – namely, whether the projects leading to the construction of sites and production lines have “significant”, “slight” or “trivial” environmental impacts and whether the projects located in environmental sensitive area. Normally, the Feasibility Study Reports or FSRs (before the effectiveness of *the Decision of the State Council on Reform of Investment System* on July 16, 2004, the “Decision”) or Project Application Reports / Project Filing Application (the substitutes of the FSRs upon effectiveness of the Decision) filed by future owners at the government authority in charge of investment will describe the raw materials, the processing methods and steps, and the finished products – which may help you in categorizing the projects into the List, and then make a judgment of the kinds of EIA will be needed.

### 3.1.2 Qualification Of EIA Auditors

There are two types of qualification certificates for EIA in China: A and B. Entities with A certificates can appraise environmental impacts of construction projects approved by both the state and local governments, while those with B certificates can only appraise the environmental impact of projects approved by local governments. Both A and B certificates will be issued by the MEP, specifying the scope of environmental impact business can be taken by the certificate holders. Each qualification certificate has a life of four years, subject to renewal.

EIA Reports or EIA Forms will be acceptable to the environmental protection authority only if they are prepared by the entities which have appropriate type of qualification certificates and have the assessment tasks within the scope of business specified in the qualification certificate. Zoom-out copies of the qualification certificates should be attached to the EIA Reports or EIA Forms they prepared. Names and qualifications of qualified agencies are available at the website of MEP.

Competency of auditors is usually not a problem to EIA documents submitting to the MEP or to its provincial subordinates. However, you should be vigilant to those submitting to city and county levels – the qualification certificates may be out of date, or they do not cover the EIA services of the subject matter.

### 3.1.3 Competency Of Environmental Protection Administrations

Under the environmental laws of China, the MEP is the highest government authority reviewing and approving EIA documents. In principle, MEP is responsible for reviewing the EIA documents for the following projects:

- *Construction of nuclear facilities and top-state-secret projects;*
- *Projects crossing the borders of provinces, autonomous regions and state-directed cities; or*
- *Projects approved by the State Council or by any authority with the State Council's delegation.*

At local level, the allocation of approval authority of provincial, city, and county environmental protection administrations are decided by the relevant provincial government by local rules. Despite of the difference from locale to locale, most provincial governments vest the provincial environmental protection administration the power of reviewing the EIA documents for the following projects:

- *Projects the review and approval of which are delegated by the SEPA;*
- *Projects that cross the borders of cities and counties;*



- *Projects approved by the provincial government or a government department with the provincial government's delegation; or*
- *Projects that needs to compile environmental impact assessment report.*

One of the biggest problems in China is that local environmental protection administrations -- especially at the city and county levels -- often exceed their authority by approving projects under its upper-level's jurisdiction, which usually accompany with local government's approval for projects beyond their authority – both are illegal under the environmental laws of China. Therefore, it is very important to verify the competency of the environmental protection administrations which issue the approval to the EIA documents.

#### 3.1.4 Review Description In EIA Documents

Generically, you can trust the EIA documents which were drafted by qualified agencies and approved by the competent environmental protection administrations – challenging the technical ground of such EIA documents seems unnecessary unless you have good reasons to do so. However, you still need to pay attention to the content of the EIA documents.

Despite of the magnificent difference in terms of depth and width, EIA Reports, EIA Forms and EIRs should include the analysis of possible impacts the project may bring to the environment, suggestions on pollutant control and treatment and their technical and economical feasibility, as well as the key elements that may influence the effect of pollutant resolution. Generally, the EIRs will end up with an conclusion that the subject project will only bring trivial impacts to the environment and therefore do not merit special pollutant control and treatment solution; EIA Forms with a conclusion that the environmental impacts may be limited to a short term in a small area or the pollution can be dealt with simple and low-cost treatment facilities – either of which will bring significant risks to the developers. The ones that really need attention are EIA Reports.

In an full-text EIA Report (you may have learned these in this chapter above), the appraisers will spend a quality part of content to analyze the types and quantity of pollutants that may be produced in different manufacturing steps, and work out technical plans to mitigate the pollutions so that the final discharged pollutants will not exceed the input capacity of the outside environment. The EIA Report will also include the acceptable discharging criteria (quantity and density of each pollutants) and the key elements that may influence the success of the technical plan.

The technical plan will serve as the basis for designing the pollutant control and treatment facilities in the following steps. The quantity and density of each pollutants will be converted into the permitted pollutant discharging standards specified in the discharging licenses issued by the competent environment protection administration. The management of the key elements will determine the success of the pollution control outcome in day-to-day operation. All this information will help you to assess the overall environmental risks of the target. This is also the reason while your review of environmental documents should start with EIA process.

### **3.2 Confirm Satisfaction With “Three Concurrence” Requirements**

After the EIA documents have been approved, the developer of the subject project will deliver the pollutant control plan to the designer, which will be responsible for putting all plans of the project together and reflect them in the design papers. Before issuing of the Planning Permit for Construction Works, the relevant city zoning administration or the government department in charge of investment will organize experts from the developer, the designer and different government agencies to review the initial design drawings – the environmental protection administration will usually be invited to join and have their say to the design to

ensure the first “concurrency” – the design of pollutant control and treatment facilities being made concurrently with that of the main facility.

Environmental impact administrations usually do not supervise the construction process. Their way to ensure the satisfaction of the other two “concurrency”— i.e. the construction and completion of the pollution control and construction facility being conducted concurrently with those of the main facility – is in the final inspection process: the finished pollution control and treatment facility should be operated with the desirable results, evidenced by the output data sampled and tested by the local environment monitoring agency.

Only after the pollutant control and treatment facility have passed the final inspection can the developer put the main facility into operation. However, developers may conduct “trial production” – putting the main production facility and the pollutant control and treatment facility into use on a tentative basis to check the effectiveness and efficiency of both facilities. Trial production also requires the approval of the competent environmental protection administration, and the applicant for the trial production should apply for final inspection within three months following the trial production is approved. However, under some circumstances, the term for trial production may be extended up to 1 year upon application by the developers and approval from competent environmental protection administration.

A typical problem on this front is, lots of Chinese companies start production before the final inspection of the pollutant control and treatment facility – some of them start without the approval for trial production; some of them have obtained the approval for trial production but have not applied for final inspection over years. Some of the trial production are issued by incompetent environment protection administration – again, often at city or county level. By checking the financial and operating information (to figure out the starting time of production) and the approval documents issued by the environmental protection administrations in respect of the trial production and final inspection, you can find whether the target has this problem.

### **3.3 Review Pollutant Registration Documents**

Within a month after the final inspection, the owners (the former developers) of construction projects should register the main pollutants to be discharged at the city or county level of environmental protection administration (the authority between city or county environmental protection administration is basically decided by the provincial government or provincial environmental protection administration, with a few except that in the major pollution-control drainage basins such as Huai River and Tai Lake, the authority between city or county environmental protection administration is divided in accordance with the volume of certain pollutants. Checking local rules is therefore necessary). Pollutant registration is an essentially procedural issue since there is nothing new in the registration form but repeating the controlling standards and requirements specified in the confirmation letter for the final inspection of the pollutant control and treatment facilities.

Owners of industrial sites should make annual registration for pollutant discharge to the environmental protection administration reporting the situation of pollutant discharge in the year concerned. If any of the pollutant is discharged exceeding the controlling standards, the owner or operator should explain the reason and set out a plan of solving the problem within a time limit (one to three months). The annual registration forms are filed at and reviewed by the city or county environmental protection administration.

The annual registration forms are important since: (i) as discussed in the paragraphs below, the annual registration forms often contain all pollutant control standards, while the discharging permits only lists the pollutants to water and atmosphere; and (ii) if the environmental protection administration indicates any over-discharge in the annual registration forms, you need to assess the nature and extent of the problem and the cost of correction.

### **3.4 Discharging Permits**

Discharging permits are government approvals for the owner of an industrial site to discharge pollutants within the given standards and quotas. An official discharging permit include two documents: one called Formal Copy (*Zhengben* in Chinese) is required to put in an outstanding place (usually alongside the Formal Business License and other similar permits and registrations) for future government inspection; another called Duplicated Copy (*Fuben* in Chinese) contains the most important information – the permitted pollutant standards and quotas.

There are two types of discharging permits: normal and temporary. A normal discharging permit will have a valid period for three to five years (renewable); and the life span of a temporary one will be under a year. If you happen to identify a temporary discharging permit, be cautious – because it usually suggests that the target has a significant over-discharge problem and such a problem should be corrected within the life span of the temporary discharging permit – failing to accomplish this may lead to suspension of the production activities in the worst cases.

### **3.5 Review Environmental Monitor Reports**

The monitoring agencies under local environmental protection administrations are responsible for sampling and testing the pollutants (usually those substance controlled by way of discharging permits) discharged to the outside environment. The monitor can be periodic (e.g. once a month), irregular, or continuous (i.e. monitor is made by electronic apparatus continuously installed at discharging points). Comparing the monitor results with the parameters of permitted discharge will help you understand whether the target complies with the pollutant control requirements in substance.

### **3.6 Review Documents For Payment Of Discharging Fees**

Documents for payment of discharging fees provide another way to double check the compliance with the pollutant control requirements. For example, you can know from the name of the payment (discharging fees or over-discharging fees) that whether the target has a over-charge problem. Further, as all the discharging fees are calculated according to *the Administrative Measures on the Standards of Collection of Discharging Fees* (promulgated jointly by the Ministry of Finance, the SEPA, the former State Development and Planning Commission and the former State Economic and Trade Commission on February 28, 2003), you can retrieve the volume of the pollutants discharged by the target in a given period from the calculation formula, and compare the results with the number specified in the discharging permits. This double check will help you confirm the reliability of the information provided by the target – and by the local environmental protection administrations and, by exploring the cause of inconsistency, you may be able to identify the real environmental problems, if any.

### **3.7 Review Documents Related To Environmental Accidents And Disputes**

This is the most difficult step in environmental due diligence. There are no publicly available channels to check the environmental accidents and disputes. You have no other choice but to rely on the information furnished by the target and the local environmental protection administrations. Exploring the media and visiting residents living nearby can be a help, but the chance for identify environmental accidents and disputes is not positive in most cases.

Resorting to financial auditors turns out to be an effective way to tackle this problem. If the target has environmental accidents and disputes, there might have been some expenses for retaining lawyers or for settlement of the claims, or for payment of administrative penalties. Such clues will help you to trace down what had happened in the past.

### **3.8 Review Documents Related To Environmental Management**

Assessment of target's environmental management usually includes the following aspects:

- (A) Environmental management system, i.e. whether the target has passed the ISO14001;
- (B) Contractual environment management, i.e. whether the target has contracted its environment management to a third party, and whether the third party has appropriate and necessary qualifications and licenses for dealing with the environmental problems;
- (C) Internal review of environmental issues, i.e. whether the target has an internal review committee or top official to regularly review its environmental issues, and/or whether the target has retained outside agencies to audit its environmental compliance and, if any, the results.

The aforementioned information will help you to assess the capability of target's understanding and management of significant environmental risks, but will not help you to find what and where the problem is.

### **3.9 And Next...**

If you are satisfied with the findings through the preceding process, the target would have substantially complied with the environmental laws of China, and therefore the associated risks would not be significant. But be careful before drawing any optimistic conclusion – same as to other due diligence, documents review cannot dig out all problems. You have to take other factors into account.

If you find there is any site or production line the construction of which has not obtained all or any government approvals, consider the following steps:

- (a) Confirming the time of construction

If the construction was made before 1996, the reason for not obtaining government approvals may be the local government had not set up its separate environmental protection administration, or the local environmental protection administration had not started to accept EIA documents, or there is no EIA agency available in practice. You have to be pragmatic under such circumstance – that is, if the target constructed pollutant control and treatment facility in a later time and the facility was accepted by the local environmental protection administration, and the target has successfully made pollutant registration and obtained discharging permit, the risks would normally not be significant.

- (b) Confirming the form of the required EIA documents.

Basically, projects requiring EIRs would not be problematic – though there might be some procedural matters to be sorted out. Project requiring EIA Forms may cause some problems, but the correction would usually not be cost-consuming nor technically complex, and the supervisory environmental protection administrations are at the city and county level – not very difficult to deal with.

The real problem is the projects that require EIA Reports but the target has failed to do so. Because of lack of the necessary EIA process and effective solution to deal with the pollutants, the target may have cause serious environmental problems. You may have to get environmental auditors involved.

## **4. CHECKLIST OF REQUESTED DOCUMENTS (4.0)**

### **4.1 Particulars Of Site Operation**

- (1) List of all sites of the target, together with the nature of operation (including the operations of prior owners/operators), brief of surrounding facilities (i.e. neighbouring residence and factory facilities, schools, hospitals etc. and their locations and distances to the site);
- (2) Financial and operational information of all sites, specifying (if applicable) the number of production lines of each site, the raw materials, processing steps, and number of finished products;
- (3) Financial information of new construction, upgrading, and/or change of use of production lines of each site, specifying the time of commencement and completion of the construction, upgrading, and/or change of use;
- (4) Financial information of new construction, upgrading and change of use of pollution treatment facilities, specifying the time of commencement and completion of the construction, upgrading, and/or change of use of the facilities; and
- (5) Geological, hydrological and meteorological information of each site (if possible), and the overall capacity available to each site for discharging contaminant substances in waste, wastewater, and gas.

#### **4.2 Environmental Management**

- (1) All internal rules, procedures, guidelines, handbooks, training materials and best-practice advice formulated by or applicable to each site related to environmental issues;
- (2) Target's policy on review of environmental issues (e.g. does the target conduct regular reviews or are reviews done only on an as-needed basis), and all reports of such review, if any;
- (3) Titles and responsibility of each member of environmental policy and/or review committee of the target (if any);
- (4) All documents related to environmental management department, including functions, responsibilities, engineering qualifications and experiences of each staff in the department;
- (5) All plans to cope with environmental accidents;
- (6) Operating and maintenance budgets which will indicate the amount of funds set aside for upkeep of pollution treatment facilities;
- (7) All agreements with outside consultants and/or companies regarding advising and assisting disposal of pollutants and other environmental issues;
- (8) All documents related to citizen complaints and their resolutions;
- (9) All environmental auditing reports, done either by internally taskforce or by outside consultant(s); and
- (10) All permits and licenses for discharging pollutants.

#### **4.3 Regulatory Compliance**

- (1) All report of environmental impact, environmental assessment report and approval opinion from the environmental protection authority therefor;

- (2) All approvals from environmental protection authorities approving design of pollution treatment facilities as well as final inspection and acceptance the pollution treatment facilities;
- (3) Any approvals from environmental protection authorities with respect to upgrade or dismantle pollution treatment facilities;
- (4) The standard (including general quantity and density) for discharging;
- (5) List of hazardous waste discharged in each site and all permits for the discharging, storage, transportation and disposal of hazardous waste;
- (6) All documents issued by the environmental administrations to the target concerning penalty, investigation, rectification orders;
- (7) All information concerning environmental accidents occurred in each site (including those occurred by or related to prior owners/operators); and
- (8) All certificates or vouchers of the target's payment of pollutant discharging levies in the past three years, including over-discharging fees.

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