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PRC Supreme Court Clears Path for Shareholders' VAM

In the past, international private equity (PE) and venture capital (VC) investors could be nervous about the fate of net profit guarantee and other value adjustment mechanisms (VAM) underpinning their investment agreements in China. They may now, however, take some comfort in a recent decision rendered by the Supreme People's Court of China (Supreme Court).

This article originally appeared in *IFLR* on January 21, 2013.

Haifu v Gansu Shiheng, a closely-watched case out of Gansu, queried for the first time in publicised court proceedings the enforceability of net profit guarantee arrangements. The long-awaited decision of the Supreme Court provides much needed clarity and assurance on this critical issue. It also sheds some light on how VAM should be structured and documented when the PRC foreign investment approval authorities seem to increasingly demand standardised contracts and documents, including articles of association and joint venture contract. However, short of an overhaul of China's Company Law, foreign investment laws and foreign exchange control regime, a single welcoming decision of the Supreme Court cannot create the degree of flexibility and enforcement assurance to which international financial investors are accustomed in more mature markets.

A long march from two courts in Gansu to the Supreme Court in Beijing

The Haifu case took nearly three years, marching through two courts in Gansu province before it was finally concluded at the Supreme Court in Beijing at the end of 2012. While on this journey, the case took some dramatic twists and turns.

In 2007, Chinese VC investor Suzhou Industrial Park Haifu Investment (Haifu) proposed to invest RMB20 million in Gansu Shiheng Nonferrous Metals Recycling, a foreign-invested company (Company) for a 3.85% equity interest. Haifu, the Company, the Hong Kong company that was then the sole shareholder of the Company (Hong Kong Parent) and an

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individual entered into a Capital Increase Agreement, which contained the following clause (NP Guarantee Clause):

"The Company's net profit in 2008 shall not be less than RMB30,000,000. If the Company's actual net profit in 2008 does not reach RMB30,000,000, Haifu is entitled to demand cash compensation from the Company in an amount equal to (1-2008 actual NP / 30,000,000) x 20,000,000; if the Company fails to so compensate Haifu, Haifu shall have the right to demand such compensation from the Hong Kong Parent."

Following the signing of the Capital Increase Agreement, Haifu and the Hong Kong Parent also entered into a joint venture contract, pursuant to which Haifu contributed RMB20 million to the Company. RMB1.15 million of this amount went into the Company's registered capital, representing a 3.85% equity interest, while the balance of RMB18.85 million was recorded as a capital surplus. Under the joint venture contract and the Company's articles of association, the net profit of the Company would be distributed between the two equity owners in proportion to their respective equity interests.

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It turned out that the Company's actual net profit in 2008 was a mere RMB26,858. Relying on the NP Guarantee Clause, Haifu sued the Company and the Hong Kong Parent, demanding cash compensation in the amount of RMB19.98 million, calculated in accordance with the NP Guarantee Clause. That amount was nearly Haifu's entire RMB20 million funding.

The court of first instance, the Intermediate People's Court of Lanzhou (Lanzhou Court), concluded that the NP Guarantee Clause did not provide a legally valid basis for Haifu to demand compensation from the Company. The Lanzhou Court reasoned that first of all, the NP Guarantee Clause is essentially equivalent to giving Haifu a profit distribution disproportionate to its equity interest in violation of the Sino-Foreign Equity Joint Venture Enterprise Law (the EJV Law), which requires profit distribution to be proportionate to each partner's share in the registered capital. Second, the court reasoned that it violates the PRC Company Law by damaging the interests of the Company and its creditors. Consequently, the court rejected Haifu's demand for compensation from the Company. Further, the court rejected Haifu's demand for compensation from the Hong Kong Parent, reasoning that the Joint Venture Contract should prevail over the inconsistent Capital Increase Agreement. Haifu appealed.

The court of second instance, the High People's Court of Gansu Province (Gansu Court), also found the NP Guarantee Clause to be invalid. However, it developed a surprising line of reasoning. First, the court stated that the NP Guarantee Clause violates the doctrine that investors should share investment risks, thus setting the stage for its next line of reasoning to ultimately invalidate the NP Guarantee Clause. Relying on an antiquated judicial interpretation of the adjudication of joint cooperation contract

disputes, the court concluded that the NP Guarantee Clause is invalid and that the RMB18.85 million capital surplus portion of Haifu's funding was not equity investment, but should be characterised as a loan to the Company which, together with interest, should be returned to Haifu by the Company and the Hong Kong Parent. While Haifu lost its contractual claim for compensation under the Capital Increase Agreement, it would nonetheless expect to recover a vast majority of its investment while keeping its original equity stake in the Company. Indeed, the Gansu Court granted the kind of remedy that was not claimed by Haifu. Further, it based its rulings on a doctrine and an antiquated judicial interpretation ranked low in the hierarchy of PRC sources of law, while clearly ignoring conflicting or different provisions of higher ranking laws or regulations. The Company and the Hong Kong Parent appealed to the Supreme Court.

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The Supreme Court first vacated the decision of the Gansu Court, finding that the court had erred on the procedures by granting Haifu a remedy that it did not claim. What Haifu had claimed was cash compensation plus litigation costs under the NP Guarantee Clause, not a return of its investment. The Supreme Court also held that there is no legal basis for the Gansu Court to recharacterise the capital surplus portion of Haifu's investment as a loan and to order its repayment.

Consistent with the reasoning of the Lanzhou Court, the Supreme Court also concluded that the NP Guarantee Clause violates the EJV Law and the PRC Company Law and damages the interests of the Company and its creditors to the extent that it requires the Company to compensate Haifu, and therefore is invalid.

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However, the Supreme Court upheld the validity of the Hong Kong Parent's undertaking to compensate Haifu under the NP Guarantee Clause, on the ground that such agreement does not jeopardise the interests of the Company or its creditors, nor does it violate applicable laws. Confirming the finding of the lower court that the Capital Increase Agreement reflected the parties' genuine intent, the Supreme Court affirmed the Hong Kong Parent's obligation under the NP Guarantee Clause and ordered it to pay Haifu cash compensation in the amount of RMB19.98 million.

What do we learn from Haifu's long march?

The Haifu case has drawn much attention and reaction from the investment and legal communities. This is no doubt because the ultimate outcome signals the attitude of Chinese courts towards profit guarantee arrangements and other forms of VAM which are popular in PE and VC deals in China. While VAM was first introduced to China by international financial investors who attempted to replicate the

practices in more mature markets, over time it has developed with its twists and turns to suit the legal and business environment in China. There are a garden of varieties of VAMs. The terms of some may even seem draconian, which may explain why in China VAMs are referred to as gambling clauses. Yet, these VAMs did not just arrive in China, but have stayed and thrived.

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VAMs are used to address some of the challenges inherent in China's still developing legal system. For example, what might be one of the most important downside protections that a minority investor demands – ie being the first in line among the shareholders to recover its investment – cannot be achieved through liquidation preference in China. This is because under the Company Law and in practice, the preference share concept is not provided for at all in the context of limited liability companies, or has very limited utility in the context of joint stock companies. Instead, investors would have to look for protection through contractual arrangements with founders and other shareholders. VAM is also sometimes used to address pure business risks. For example, conducting a thorough due diligence and having strong confidence in a company's financial and other data is not always easy. There may also be market pressure to be flexible on due diligence. VAMs are then used to put a price tag on this risk. These conditions and limitations of the Chinese market are expected to continue in the foreseeable future and, consequently, VAMs are expected to stay. Surely, some assurance of its enforceability on the basis of sound legal reasoning is critically important, especially after the rollercoaster ride of the Haifu case through the Lanzhou Court and Gansu Court.

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Three key takeaways

The Supreme Court's decision is welcoming news indeed. First, the Supreme Court has clarified that an agreement requiring a company to guarantee net profit and pay compensation if the net profit target is not reached is invalid, as it damages the interests of the company and its creditors. While the decision was in the context of a net profit guarantee, the ruling and reasoning indicate that any VAM that would diminish the company's assets in any way in favour of a shareholder may be legally vulnerable. This, together with limitations of Chinese laws such as strict restrictions on share redemption, lack of preference share mechanism and unavailability of share issuance at nominal value, leaves few options for investors looking for some coverage from the company.

For example, investors may make a smaller equity investment initially while extending a loan that is expected to convert into equity if a certain financial performance threshold is met. However, there are regulatory obstacles to this arrangement. A company that is not at least 25% foreign-owned may not be able to borrow from its foreign owner(s). Once the 25% threshold is met, the company would be able to borrow a foreign exchange shareholder loan which may later be converted into equity. However the threshold makes this option not very practicable. Another option is for the company to be structured as a joint stock company so that it may adopt a disproportionate profit distribution scheme. If none of these options are available, the Supreme Court's decision in Haifu makes it clear that investors should look for protection from founders and other shareholders.

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Second and more importantly, the Supreme Court has confirmed that a net profit guarantee and compensation agreement among shareholders is valid and enforceable, as long as it meets the basic requirements for the formation of a contract (ie the contract reflects the genuine intent of the parties at the time). While the Haifu case involves a specific type of VAM, the affirmation by the Supreme Court should have broader and positive implications. The ruling has certainly removed a big cloud over the reliance on shareholders' agreements for investment protection. It shows that the court upholds the principle of freedom of contract while being judicious in relying on principles such as fairness or good faith to justify intervention in contractual arrangements. The decision of the Supreme Court may set the tone at the top that courts should respect commercial contracts.

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Third, the Supreme Court's decision provides some comfort and predictability in shareholders' agreements that fall outside of joint venture contracts and articles of association as the latter two documents seem to be under increasing pressure to be standardised at the request of approval and registration authorities. Notably, the Lanzhou Court invalidated the undertaking of the Hong Kong Parent to compensate Haifu under the NP Guarantee Clause on the ground that there is inconsistency between the NP Guarantee Clause contained in the Capital Increase Agreement and the provisions of the joint venture contract. The Supreme Court nonetheless recognised such undertaking of the Hong Kong Parent. In upholding the validity of such provisions, the Supreme Court applied only the basic contract formation requirements, rather than examining whether these provisions should also have been included in the joint venture contract and articles of association or whether the joint venture contract or articles of association should prevail over other investment agreements. International PE and VC investors may now take comfort in the Supreme Court's decision that VAM arrangements would likely be held by courts to be legal and valid. This would include the likes of: net profit guarantees and

resultant payment among shareholders; shareholder arrangements intended to mimic the effect of dividend or liquidation preferences; share transfers; put or call options and drag-along among shareholders; and share pledge to secure a shareholder's obligations to another.

While the Supreme Court's decision is encouraging, the Chinese legal system still has a way to go before it can provide the kind of flexibility and predictability offered in mature markets. The very fact that investors have to mostly rely on shareholders' agreements to lock in arrangements that are provided for statutorily in more mature markets shows the discrepancy. Investors should be aware that a shareholder agreement and a statutorily provided structure carry different weight in their reliability and enforceability.

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Further, in relying on VAMs among shareholders, international financial investors should be mindful that there are general principles such as fairness and good faith under the PRC Contract Law and the General Principles of Civil Law that may provide grounds for other parties to challenge the validity and enforceability of contracts. They also may provide grounds for courts to excise their discretion to set aside VAM clauses. Therefore, international financial investors should be careful not to impose extreme VAM arrangements as a way to manage due diligence risks.