Chinese Courts Rule on Value Adjustment Mechanism – Impact on PE Investments

Private equity (**PE**) investors commonly adopt a price or valuation adjustment mechanism (commonly referred to as **VAM**) when making growth capital or venture capital investments to mitigate against the uncertainty of the future financial performance of the investee company following the investment. The investment documents would usually provide that if the actual financial performance of the investee company post-investment turns out to be worse than an estimated or target financial threshold agreed by the investee company when the PE investor made its investment, the PE investor should be compensated by either cash or additional shares in the investee company.

This concept is widely adopted by PE investors in the Chinese market, both for onshore and offshore investments, but it has never been tested in front of the PRC courts until recently through the case of *Haifu v Shiheng, Wisdom Asia and Lu Bo*. Although the court of the first and second instances refused to recognise the validity of the VAM arrangement in question, the retrial judgment by the Supreme People's Court (**SPC**) on 7 November 2012 upheld the validity and enforceability of the VAM arrangement as a matter between the shareholders (i.e. between the PE investor and the controlling shareholder) but held that the VAM arrangement between the PE investor and the investee company was invalid and unenforceable. The SPC's position on the validity of VAM arrangements between shareholders should offer PE investors some comfort when structuring a VAM in the context of an onshore investment. However, one should be mindful of the limited binding force of such judgment as China is a civil law and not a common law jurisdiction.

Key issues

Case overview

Background

In October 2007, Haifu Investment Co., Ltd. (海富投资有限公司) (**Haifu**), a PE investor based in Suzhou, PRC, invested RMB20 million in Gansu Zhongxing Zinc Co., Ltd. (which later changed its name to Gansu Shiheng Non-Ferrous Resources Recycle Co., Ltd.) (**Shiheng**) to subscribe for the capital increase in Shiheng. Shiheng is a foreign-invested enterprise then wholly owned by Wisdom Asia Limited (**Wisdom Asia**), a Hong Kong incorporated company. Upon completion of the investment, Haifu held 3.85% of the equity interests in Shiheng, while the remaining 96.15% continued to be owned by Wisdom Asia. Out of the RMB20 million invested by Haifu, approximately RMB1.14 million was recorded under the

registered capital of Shiheng while the remainder was recorded into the capital reserve account of Shiheng (**Capital Reserve Portion**).

According to the subscription agreement entered into between Haifu, Shiheng, Wisdom Asia and Lu Bo (the *de facto* controller of Shiheng) in respect of this investment, if the actual net profit of Shiheng for the financial year of 2008 is less than RMB30 million, Haifu is entitled to claim a cash compensation from Shiheng or, in the event of Shiheng failing to pay such compensation, from Wisdom Asia in accordance with an agreed formula of (1 – actual net profit of 2008 / RMB30 million) x the invested amount (**VAM Arrangement**).

Shiheng's actual net profit for the financial year of 2008 turned out to be RMB26,858 (i.e. far lower than the target net profit), based on which Haifu exercised its entitlement to cash compensation of RMB19,982,095 under the VAM Arrangement. Both Shiheng and Wisdom Asia refused to perform their respective compensation obligations under the VAM Arrangement and Haifu subsequently filed a suit against Shiheng, Wisdom Asia and Lu Bo with the local court.

Courts' decisions

The key issue in this case was whether the VAM Arrangement was valid and enforceable under PRC laws. The court of first instance denied the validity of the VAM Arrangement on the basis that it contravened the principle of *pro-rata* profit distribution as stipulated under Article 8 of the Sino-Foreign Equity Joint Venture Law of PRC (**EJV Law**) and impaired the interests of Shiheng and its creditors as prohibited under Article 20 of the Companies Law of PRC. The court of first instance also referred to the inconsistency between the joint venture contract and the subscription agreement with respect to profit distribution and concluded that the joint venture contract which did not contain any VAM-related provisions should prevail. As such, Haifu's claim for cash compensation was dismissed by the court of first instance.

The judgment of the court of first instance was overruled by the court of second instance, which held the VAM Arrangement was invalid but for a different set of reasons. It was the view of the court of second instance that the VAM Arrangement essentially granted Haifu a profit guarantee, free of any investment risk. By referring to a judicial interpretation issued by the SPC, the court of second instance concluded that the Capital Reserve Portion was by nature a loan (as opposed to an equity investment) extended to Shiheng by Haifu, which should be illegal, because under PRC laws only licensed entities are qualified to provide loans. Accordingly, the court of second instance ordered Shiheng and Wisdom Asia to repay to Haifu the amount of the Capital Reserve Portion plus interest accrued.

The SPC, in its retrial judgment, partially confirmed the position and reasoning of the lower courts with respect to Shiheng's obligations under the VAM Arrangement, and re-asserted that such provision shall be invalid against Shiheng on the ground that it violates the statutory *pro-rata* profit distribution principle and the interests of its creditors. With respect to the joint liability of Wisdom Asia to compensate Haifu under the VAM Arrangement, the SPC took the view that such agreement should be valid since (i) it did not cause any harm to the interests of Shiheng or its creditors, (ii) it did not violate the mandatory laws, and (iii) it reflected the genuine intention of the parties. In light of the above, the SPC ordered Wisdom Asia to pay up the compensation in cash (i.e. RMB19,982,095) to Haifu in accordance with the VAM Arrangement.

Implications and recommendations

The Haifu case has attracted a lot of attention and discussion within the PE industry in China. Although the PRC judicial system is not established on the basis of common law, the judgment of the SPC in this case is likely to be adopted or referenced to as guidance by PRC courts in their trials of similar cases given the supreme status of the SPC in the PRC judicial system. Having said this, it remains to be seen to what extent these lower courts would follow the SPC's reasoning as they are not legally bound by the decision of the SPC.

- **For cash compensation payable by the company, avoid compensation based on net profit**

  As a matter of strict legal analysis, we do not necessarily share the view that the payment of cash compensation by the investee company to the PE investor violates the principle of pro-rata profit distribution under the EJV Law. Such an approach would cast doubt on any other payment arrangement between a company and its shareholder.

We note in the Haifu case that the cash compensation formula was based on the actual net profit of the investee company. The Haifu case does not indicate how cash compensation payable by the investee company according to a formula which is not based on net profit would be considered. For example, would a compensation formula based on internal rate of return (IRR) be enforceable?

- **Structure VAM arrangements as a matter between shareholders**

  However, given the rationale underlying SPC's decision, it would be prudent that VAM arrangements involving the payment of cash compensation be structured as a matter between the shareholders rather than as an obligation of the investee company to the PE investor.

  In addition, the VAM arrangements should be drafted in the joint venture contract and articles of association of the investee company, instead of the subscription agreement.

- **Structure VAM arrangements involving the issue of shares or transfer of shares**

  The Haifu case does not expressly cover the traditional VAM arrangements where the PE investor has the right to require the investee company to issue new shares or the controlling shareholder to transfer old shares to the PE investor, in the event that the VAM is triggered. These types of VAM arrangements should continue to be valid.

  However, for investments made by foreign PE investors, the traditional VAM arrangements are more difficult to structure and achieve under PRC laws. Relevant government approvals are required to be obtained for the increase in registered capital or the transfer of shares. In the case where the investee company has to issue new shares, generally speaking, the foreign PE investor's share of the registered capital of a PRC limited liability company cannot be increased without a corresponding "dollar for dollar" capital contribution into the investee company. Where a domestic controlling shareholder has to transfer old shares to a foreign PE investor, the application for government approval of the transfer must usually be accompanied by a valuation report evidencing that the transfer is being made at "fair value". Hence, a transfer at nominal value by the controlling shareholder may possibly be challenged by the approval authorities.

Conclusion

PE investors should welcome the SPC's decision as it confirms the validity of VAM arrangements between shareholders. However, the Haifu case creates difficulties for PE investors who would prefer to seek compensation from the investee company rather than the controlling shareholder. If you are interested in understanding more on how to structure VAM arrangements, please feel free to contact us for further insights.

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