January 21, 2013

China's Supreme Court Ruling in *Haifu v. Shiheng* Changes the Landscape for Value Adjustment Mechanisms in Onshore Private Equity Transactions

By Xiaohu Ma, Thomas Chou, Paul McKenzie and Jun Deng[1]

The Supreme People's Court of China (the "**Supreme Court**") rendered its final judgment on November 7, 2012, in the *Haifu Investment Co., Ltd. v. Gansu Shiheng Nonferrous Resources Recycle Company Limited* ("***Haifu v. Shiheng***"). Despite the Supreme Court's lack of appreciation of the role of private equity in China, the decision brings much-needed guidance to the structuring of value adjustment mechanisms ("**VAMs**") commonly used in onshore private equity ("**PE**") transactions in China.

BACKGROUND

Since the adoption of the *Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises* (关于外国投资者并购境内企业的规定) in August 2006, it has been increasingly difficult for foreign PE investors in China to make their investments through offshore holding companies. Accordingly, such foreign PE investors have increasingly invested directly in portfolio companies established onshore in the PRC.[2] Due to the rigid corporate governance associated with PRC limited liability companies, PE investors have had to utilize creative techniques to replicate the downside protections that are customary in offshore PE transactions. One of the most fundamental of such protections are VAMs, which are designed to provide the PE investor with remedies in the event the actual valuation or financial performance of the Company diverges from the valuation and performance underlying the PE investor's original valuation model. After years of speculation by industry as to the enforceability of VAMs in PRC companies, as well as inconsistent findings in the lower courts, the Supreme Court in *Haifu v. Shiheng* has delivered PE investors much-needed guidance on the types of VAM structures that may be enforceable in onshore PE investments. In doing so, the Supreme Court has also helped bring closure to the long-running court saga of *Haifu v. Shiheng* by overruling the decision of the court of appeals (which characterized a portion of such PE investments as loans for which the investor was entitled to the equivalent of the return of its principal and accrued time deposit interest) and partially overruling the decision of the court of first instance (which found VAMs categorically unenforceable against a portfolio company as well as its controlling shareholder).

---

[1] Jing Bu provided valuable support for this article.

[2] Such PRC portfolio companies are typically limited liability companies that are either domestically owned or foreign invested. A foreign invested enterprise ("**FIE**") can be in the form of a Sino-foreign equity joint venture ("**EJV**"), a Sino-foreign contractual joint venture ("**CJV**") or a wholly foreign-owned enterprise ("**WFOE**"). The parties to an EJV are required to share profits and bear risks and losses in proportion to their respective capital contributions in the joint venture; in contrast, the parties to a CJV can contractually agree to the disproportionate rights, interests and obligations in the joint venture.

KEY TAKEAWAYS

Our key observations of the Supreme Court's final judgment on *Haifu v. Shiheng* are highlighted as follows:

- VAMs in onshore PE transactions that permit a PE investor direct recourse against a portfolio company are likely to be unenforceable; in contrast, VAMs that allow a PE investor recourse over a controlling shareholder of such portfolio company are likely to be enforceable.
- The VAM in *Haifu v. Shiheng* was structured to provide a cash payment from the controlling shareholder to the PE investor. However, many VAMs are structured to require the controlling shareholder of the portfolio company to transfer a portion of its existing equity interests to the PE investor. This mechanism allows the PE investor to receive a greater percentage of the equity in the portfolio company for the same initial equity investment price, which translates to a downward adjustment to the pre-money valuation of such company. While it remains to be seen how the PRC courts will rule on equity-based VAMs, based on the rationale of *Haifu v. Shiheng*, we would anticipate VAMs that provide for the controlling shareholders to transfer their existing equity interests in the portfolio company to the PE investor would likely be enforceable.[3]
- Side agreements or side letters containing VAMs and other terms and conditions of a PE investment in an FIE may be enforced by the PRC courts if they are filed along with the joint venture contract and articles of association with the relevant approval authority. While some PE investors have been reluctant to file such side agreements with the relevant approval authorities, *Haifu v. Shiheng* provides greater incentive for PE investors to include such side letters in the joint venture filings to the relevant approval authorities.
- Despite the Supreme Court's validation of a VAM against a controlling shareholder, the court's rationale did not acknowledge the principles of PE investment underlying the VAM. Instead, the Supreme Court continued to adjudicate the case based on relatively rigid principles of the EJV Law (as defined below). Accordingly, it would not be appropriate to extrapolate that this case reflects the Supreme Court's appreciation of the interests and investment rationales of PE investors in China.

VAM AND RELATED PRACTICES IN CHINA

A VAM refers to a mechanism that enables a PE investor to invest in a portfolio company based on an estimated pre-money valuation of the company that assumes certain post-closing financial or milestone-based performance targets will be achieved (e.g., that the portfolio company will achieve a minimum EBITDA for one or more fiscal years following the investment). In the event the portfolio company fails to achieve such targets, an adjustment will be made to the pre-money valuation of the portfolio company at which the PE investor made its initial investment. The mechanics of a VAM sometimes require the portfolio company and/or the controlling shareholders of the portfolio company to compensate the investor in cash or, more commonly, require the controlling shareholder to transfer a portion of its equity to the PE investor. The equity-based VAM does not require cash to exit the portfolio company prematurely, but puts the PE investor in the same equity holding position it would have been if initially invested in such portfolio company at the adjusted (reduced) valuation. Depending on the negotiating leverage of the controlling shareholder, a VAM may also be structured to require the PE investor to transfer equity to the controlling shareholder in the event the portfolio company outperforms the pre-agreed-upon performance targets.

While the VAM is often used as a legitimate tool to bridge gaps in valuation expectations between the PE investor and controlling shareholders, its application in China has been controversial. For example, it is commonly referred to in China as a "gambling agreement" or "对赌协议 (*duidu xieyi*)," a term with a very negative

[3] If such equity transfer relates to an equity interest in an FIE or one of the controlling shareholders is a state-owned enterprise, such transfer will be subject to certain statutory approval requirements.

connotation to the layperson in China. The public's impression of VAMs has not been aided by negative media reports covering VAMs in China. Such reports often take a populist outlook, do not accurately describe such VAMs and suggest that VAMs enable the greed of PE investors by allowing them to generate outsized returns without bearing corresponding investment risk.

THE CASE

Haifu Investment Co., Ltd. (the "**Investor**") is a PE investment firm organized in Jiangsu Province, the PRC. In 2007, it entered into a capital increase agreement (the "**Investment Agreement**") with Gansu Shiheng Nonferrous Resources Recycle Company Limited (the "**Company**"), providing that the Investor would invest RMB20 million in exchange for a 3.85% equity interest in the registered capital of the Company. The Investment Agreement also contained a VAM providing that if the net profit of the Company for 2008 was less than RMB30 million, the Investor would be entitled to cash compensation from the Company as follows:

Compensation Amount = (1 – Actual 2008 Net Profit／RMB30 million) × RMB20 million

If the Company did not make such payment to the Investor, the Investor would be entitled to compensation from the Company's controlling shareholder, Wisdom Asia Limited (the "**Controlling Shareholder**"), a company incorporated in Hong Kong (the "**Haifu VAM Terms**").

The actual 2008 net profit of the Company was disappointing, only RMB26,858.13. In other words, its actual net profit was less than 0.1% of its targeted net profit. As stipulated by the Haifu VAM Terms, the Company was required to return RMB19,980,000 in cash to the Investor as compensation. The Company failed to make such compensation payment and the Investor subsequently filed an action against the Company and the Controlling Shareholder to seek enforcement of the Haifu VAM Terms.

Haifu v. Shiheng was initially heard and adjudicated at the local level in Gansu Province. Both the court of first instance, the Intermediate Court of Lanzhou Municipality (the "**Lanzhou Intermediate Court**"), and the court of appeal, the High Court of Gansu Province (the "**Gansu High Court**"), held the disputed VAM invalid, but on different grounds.

Judgment of the Court of First Instance

After hearing *Haifu v. Shiheng*, the Lanzhou Intermediate Court held in its judgment rendered on December 31, 2010, that the Haifu VAM Terms were invalid because the Haifu VAM Terms contravened Article 8 of the *Sino-foreign Equity Joint Venture Law* (中外合资经营企业法) (the "**EJV Law**"), which stipulates that the parties to an EJV are entitled to distribution of net profit of the EJV in proportion to their respective contributions to the registered capital (i.e., their respective equity interests). According to the Lanzhou Intermediate Court, by requiring the Company to pay the Investor an amount disproportionate to its equity percentage in the registered capital of the Company, the Haifu VAM Terms prejudiced the interests of the Company and its creditors, and therefore the Investor was not entitled to any payment from either the Company or the Controlling Shareholder.

Judgment of the Court of Appeal

The Investor appealed the Lanzhou Intermediate Court's ruling, and Gansu High Court rendered its judgment on September 29, 2011. In its decision, the Gansu High Court did not dispute the fact that the Company was an EJV, but surprisingly analogized the business arrangements made among the Investor, the Company and the

Controlling Shareholder to an “economic association” or “joint operation” (联营), a business relationship defined and regulated under Section 4 of Chapter Three of *the General Principles of Civil Law* (民法通则).[4] The court relied on Section 4 of the *Replies of the Supreme Court to Several Questions with Regard to Trials Involving Contractual Disputes Relating to Economic Associations* issued by the Supreme Court over 22 years ago on November 12, 1990,[5] which provides that if a party to an economic association does not participate in the operations of the association but is nevertheless entitled to receive a guaranteed return without regard to the association’s profitability, this party’s investment in the association should be treated as a loan. In such a case, the courts are required to treat any contract providing for such guaranteed returns as void.[6] Finding that the Haifu VAM Terms satisfied the foregoing test with respect to a void economic association contract, the court held the Haifu VAM Terms void, treated the Investor’s investment in excess of the portion credited as registered capital of the Company as a loan[7] and ordered the Company to pay the principal plus an accrued interest calculated based on a standard time deposit interest rate.

Ironically, the rationale that the court relied on in rendering its judgment was not advanced by any of the parties during the proceeding, and the total amount ordered payable to the Investor according to the Gansu High Court’s judgment was higher than the amount claimed by the Investor. Hence, neither the Company nor the Controlling Shareholder was satisfied with the decision and both petitioned for a retrial by the Supreme Court.[8]

The judgments of both the court of first instance and the court of appeal caused significant concern to the PE investment community, as neither of these judgments adopted a rationale that suggested an understanding or acknowledgment of the legitimate and customary role of a VAM in a private equity transaction. As a result, when this case was brought to a retrial by the Supreme Court on April 10, 2012, it attracted the immediate attention of the investment community and extensive media coverage.

Judgment of the Supreme Court

The Supreme Court did not dispute the facts found by the Lanzhou Intermediate Court and the Gansu High Court, but found that the Company was an EJV, and there was no legal ground to support the conclusion of the Gansu High Court that the Investor’s investment in the Company was a loan in the guise of a “business association” (*名为联营实为借贷*). Accordingly, the Supreme Court ruled against the Gansu High Court’s rationale to treat the Investor’s investment as a loan. In addition, the Supreme Court also found that the Gansu High Court erred in ordering the Company to repay the principal amount of investment and the accrued interest, because it was beyond the claims of the Investor.

---

[4] An “economic association” or “joint operation” is a dated form of business association used in the 1980s before the Companies Law of the PRC was enacted in 1993. In addition, China also enacted the Partnership Law in 2006 and amended it once in 2010. Business arrangements previously made in the form of an “economic association” are now largely regulated under the Companies Law and the Partnership Law. Accordingly, this form of business association is rarely used in current practice.

[5] Note again that these replies of the Supreme Court were issued before the Companies Law of the PRC was enacted in 1993.

[6] Under Chinese law, only banks and financial institutions are licensed to provide loans, and loans made by an entity without such a license, such as the Investor’s investment in the Company as so deemed by the Gansu High Court, are deemed to be void, and the party making such a loan may be able to have only the principal of its investment repaid together with a standard-rate interest.

[7] According to the Investment Agreement, only RMB1,114,771 out of RMB20,000,000 invested by the Investor was credited as the Investor’s contribution to the registered capital of the Company.

[8] Under Chinese civil procedure law, a court of second instance is that of last instance and its judgment on a case is final with respect to that case and is binding on the concerned parties. However, Chinese civil procedure law also permits a grieved party to file a retrial petition to a court of higher level, which may or may not accept such petition. The retrial court may overrule or revise the final judgment of the court of second instance should it find such judgment is incorrect in its retrial.

The Supreme Court approached the issues in a different manner than the court of first instance. In short, the Supreme Court separately analyzed the claims of the Investor against the Company and the claims of the Investor against the Controlling Shareholder.

With respect to the Investor's claims against the Company, the Supreme Court found that the Haifu VAM Terms would warrant the Investor a relatively fixed return on its investment regardless of the operating results of the Company, which would be detrimental to the interests of the Company and its creditors. As such, the Supreme Court concurred with the Lanzhou Intermediate Court and the Gansu High Court that the Haifu VAM Terms against the Company were void.

With respect to the Investor's claims against the Controlling Shareholder, however, the Supreme Court held that the undertaking given by the Controlling Shareholder to compensate the Investor under the Haifu VAM Terms did not harm any interests of the Company or its creditors, nor did these terms contravene any prohibitive provisions of any existing laws and regulations, and as such, they were valid and enforceable. The Controlling Shareholder was ordered to pay RMB19,980,000 to the Investor in accordance with the Haifu VAM Terms.

OUR KEY OBSERVATIONS

We have the following key observations with respect to the Supreme Court's judgment on *Haifu v. Shiheng*:

Greater clarity on enforceability of VAMs against controlling shareholders

China's legal regime is based on civil law, and therefore the judgment rendered by the Supreme Court on any individual case does not bind the courts of lower level. However, the judgments of the Supreme Court, as China's top judicial organ, in practice will carry weight with Chinese judges. As such, we expect that the court's final judgment on *Haifu v. Shiheng* will largely be adhered to by most of the courts in China, thereby providing greater clarity as to how courts will treat VAMs going forward. In short, based on the Supreme Court's judgment on *Haifu v. Shiheng*, VAMs that permit a PE investor to claim cash compensation against a portfolio company are likely to be unenforceable. In contrast, an undertaking given by the controlling shareholder to compensate a PE investor under a VAM is likely to be enforceable. This is an important distinction, as many VAMs in offshore PE transactions also provide the PE investor recourse against the controlling shareholder rather than the portfolio company. The rationale for doing so is because if the PE investor had recourse against the portfolio company (particularly in the form of cash payments), the proceeds used to satisfy the PE investor would reduce the underlying assets of the portfolio company, as well as the working capital needed by the portfolio company to achieve its business and financial milestones. This in turn would diminish the value of the equity held by the PE investor. In contrast, if the proceeds are to be recovered from the controlling shareholder, it will not reduce the assets available in the portfolio company or dilute the value of its equity. Of course, if a VAM is overly aggressive, it may no longer incentivize the controlling shareholder to devote its efforts to the portfolio company, but such issues can be commercially managed when structuring the terms of the VAM. From a practical point of view, even if it was not the Supreme Court's intention, the judgment gives the PE investor a commercial argument to seek cash-based recourse against a controlling shareholder, rather than direct recourse against the portfolio company.

Enforceability issues related to equity-based VAMs

Haifu v. Shiheng did not involve or address the issue of whether a VAM providing for the transfer of a controlling shareholder's equity in favor of a PE investor in the portfolio company would be valid. Accordingly, it remains to be seen how the courts will rule on equity-based VAMs. However, based on the rationale of the Supreme Court's judgment in *Haifu v. Shiheng*, we would anticipate that VAMs that provide for the controlling shareholders to transfer existing equity interests in the portfolio company to the PE investor would likely be upheld. A crucial caveat to be noted here is that if such transfer relates to an equity interest in an FIE, such transfer will require the pre-requisite approval of the Ministry of Commerce or its counterpart at the local level (the "**FIE Approval Authority**"). Similarly, if the transferor of such transfer is a state-owned enterprise, the transfer may involve approval by or filing requirements with the relevant governmental authority in charge of the state-owned assets.

Issues relating to side letters

In practice, to facilitate approval by the relevant FIE Approval Authority for establishing a Sino-foreign joint venture, many PE investors choose to submit to the FIE Approval Authority a conventional and standard form of joint venture contract.[9] Separately, the parties often enter into a separate arrangement with the portfolio company and the controlling shareholder(s) providing for terms (including VAMs) that are customary in international PE transactions. These arrangements are often memorialized in a side letter to avoid scrutiny by the FIE Approval Authority and to mitigate the risk of a rejection by the FIE Approval Authority.

The Haifu VAM Terms were set out in the Investment Agreement but were not subsequently included in the joint venture contract of the Company. However, the Investment Agreement was submitted together with the joint venture contract and articles of association of the Company to and approved by the Department of Commerce of Gansu Province, the FIE Approval Authority having jurisdiction over the Company. The Company and the Controlling Shareholder argued in the trial that the Investment had been replaced and superseded by the joint venture contract by virtue of an "entire agreement" or "integration" clause of the joint venture contract,[10] and therefore the Haifu VAM Terms were no longer valid. The Gansu High Court did not accept this argument. Rather, it specifically found that the Investment Agreement had been approved by the relevant FIE Approval Authority, a finding that was affirmed by the Supreme Court. Although it was not clearly mentioned in its holding, we believe that the approval by the relevant FIE Approval Authority of the Investment Agreement was a key factor in the court's decision to uphold the Investor's claims against the Controlling Shareholder under the Haifu VAT Terms. This highlights the importance of having a side letter approved by the FIE Approval Authority to ensure its enforceability when disputes arise out of such agreement.

The Supreme Court's finding on this point should be understood in light of a prior set of rules adopted by the Supreme Court governing side letters in joint venture transactions. These rules, issued on May 17, 2010, instruct the courts of lower level that a side letter ought to be upheld as a valid agreement even if it has not been reviewed or approved by the relevant FIE Approval Authority so long as the side letter does not constitute a material or substantial change to the joint venture contract originally approved by the FIE Approval Authority.[11] In our view, a

[9] An FIE Approval Authority typically expects to only review and approve a joint venture contract prepared based on the standard form endorsed by the authority. If the standard form is not followed or substantial amendments are made to the standard form, it may prevent the applicant from obtaining the approval in a timely manner.

[10] This "entire agreement" clause contained in the joint venture contract of the Company stipulates that the joint venture contract shall replace and supersede all prior oral or written agreements, contracts, representations or understandings made between the parties with respect to the matters set forth in the joint venture contract.

[11] *Rules on Several Issues Relating to Trials of Disputes Concerning Foreign Invested Enterprises (I)* (关于审理外商投资企业纠纷案件若干问题的规定) adopted by the Supreme Court on May 17, 2010. Under these rules, with respect to the joint venture contract of a Sino-foreign joint venture, the terms relating to its registered capital; the nature of the company and its scope of business; its duration; the amount and form of capital contributions; equity transfer; and the company's merger and split events are considered material and substantial.

VAM provision would likely be viewed as a material change to the joint venture contract, and therefore best practices would dictate that PE investors submit side letters providing for a VAM with the FIE Approval Authority.

No advancement in the appreciation of PE investment principles

PE investors are willing to invest in many small and medium-sized enterprises that are traditionally neglected by PRC banking institutions or considered to have an inappropriate risk profile by other classes of investors. Given the risk profile of the companies in which PE investors invest, and PE's place in the capital structure of such companies, PE investors expect a certain internal rate of return, which they often realize only if and when such company achieves a liquidity event by way of an eventual public offering or trade sale. VAM provisions are a tool to grant PE investors some downside protection in the event the portfolio company's financial performance reduces its prospects of (or its valuation at) an exit event. However, China's current corporate law regime, in particular its foreign investment law system including the EJV Law, was largely founded in the early 1980s with a view to promoting greenfield manufacturing-oriented investments and therefore is not entirely compatible with the fundamental nature of PE investments in the current economy. At the time when *Haifu v. Shiheng* was accepted by the Supreme Court for retrial, there was genuine hope among PE investors that the Supreme Court would be more sophisticated and liberal in its understanding of, and be more willing to accept, the mode of PE investments.

Unfortunately, while the outcome of the Supreme Court's judgment on *Haifu v. Shiheng* provides PE investors in China with useful guidance on structuring VAMs, the court chose to adjudicate the case based on the conventional rigid principles of the EJV Law. To a large extent, the court's rationale did not acknowledge the principles of PE investment underlying the VAM and echoed the negative populist sentiment toward the PE industry. Many PE investors who had hoped the Supreme Court would usher in a more positive change to China's legal environment for PE investments were disappointed.

Contact:

Xiaohu Ma	**Thomas Chou**	**Paul McKenzie**	**Jun Deng**
852 2585 0868	852 2585 0848	86 10 5909 3366	852 2585 0878
xma@mofo.com	tchou@mofo.com	pmckenzie@mofo.com	jdeng@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for nine straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.