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Implementation of Select Investment Terms in China

By David Yu and Bernie Liu

Recently, RMB PE Funds have caught attention from overseas PE Fund operators, and before PRC legal system formally adopts the incorporation of RMB PE Funds in form of limited liability partnership (“LLP”) with foreign investment, certain overseas PE Fund operators have adopted different structures to set up and manage RMB PE Funds in China.

Compared to the investment tools commonly adopted by overseas PE Funds, given the PRC Company Law has not adopted the issuance of multi-layer or multi-class stocks, the investment vehicles available to PE Funds in China are limited to common stocks. In other words, the investment vehicles commonly adopted by overseas PE Funds, such as preferred shares and convertible bonds, are in general not available in China. As a result, investors shall figure out alternative risk control measures, which fit the PRC legal regime and can effectively control its investment risks.

This article discusses whether Select Investment Terms (SIT), commonly adopted as one of the risk control measures by overseas PE Funds, can be adopted by PE Funds in their investments under the PRC legal system. SIT is basically a price reset mechanism, that is, if a portfolio company issues new stocks at a price lower than the subscription price paid by the investors, the portfolio company or the founding shareholders should compensate the aggregate book loss of the investors, and at its own discretion, make compensation in lieu of cash or issuing additional shares of common stock. Since the investment vehicles such as preferred shares or convertible bonds can ensure the investment being protected by means of adjusting the conversion price, SIT generally applies for common stocks. One of the recent cases involving the implementation of SIT is Temasek Holdings’ common stock investment in Merrill Lynch. In 2007, Temasek subscribed for the common shares issued by Merril Lynch at USD 48 per share. Subsequently in 2008, Merrill Lynch newly issued common shares at USD 27.52 per share. Based on SIT, Temasek was entitled to obtain compensation valued at USD 2,500,000,000 in cash or common stock,

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and finally subscribed for common shares valued at USD 3,400,000,000 at a consideration of USD 900,000,000.

The adoption of SIT in China shall take into consideration the following factors:

- Investor

  If PE Funds are in form of foreign-invested LLP, the current laws are unclear as to whether foreign-invested LLP is subject to regulations applying to foreign-invested equity investment companies. If the portfolio companies invested by foreign-invested LLPs are deemed as foreign-invested enterprises, such investment will be subject to the laws relating to mergers and acquisitions by foreign investors and the MOFCOM approvals. Given the MOFCOM in general deems the implementation of SIT as an independent deal, it requires such implementation being approved on a separate basis; in addition, if the implementation of SIT involves issuance of common stock at a lower price, it will be more difficult to obtain the MOFCOM approval.

- Portfolio Company

  The nature of the portfolio company will affect the implementation of SIT materially. Where a portfolio company is a state-owned/collectively-owned enterprise, the issuance of common stock may involve evaluation of the portfolio company and approval by relevant administration authority of state-owned/collectively-owned assets. If the issuance of common stocks is at a price lower than the evaluation, it will be more difficult to obtain the relevant approval.

- Investment Vehicles

  If SIT is applicable to the issuance of common stocks in China, subject to the issues mentioned herein, its implementation appears to be feasible under the current PRC laws.

- Adoptability

  SIT applies when the new-round common stocks are issued at a lower price compared to the previous rounds of issuance. In comparison to veto rights, SIT allows the portfolio company to dilute the existing shareholders after paying certain consideration, imposing less restriction on the portfolio company. However, if SIT is deemed as a fixed-return or profit-guarantee clause, such terms will not be enforceable under the PRC legal system for its nature of alternative financing clauses.

To summarize, although the application of SIT has some legal basis within China, it still stands far from universally applicable risk control measures. In practice, the application of such terms depends on various factors such as the nature of investors, portfolio companies and investment vehicles, etc. In addition, if a portfolio company subject to SIT is looking for subsequent financing, its financing capacity will be restricted and its business goal may fail.

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