

Chinese courts create more flexibility for alternative transaction structures

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In two cases decided in 2012 and 2014, Chinese courts extended the way in which sellers and buyers can agree on various structures to bridge a potential value gap. Before the court rulings, a buyer might have wanted to claw-back part of the purchase price or sell back part of the equity stake (sometimes referred to as a ratchet) stemming from poor performance after closing, but the validity and enforceability in China of these ratchet structures was uncertain. Chinese courts have now removed this uncertainty in corporate transactions. The rulings show that Chinese courts are increasingly willing to accept different forms of transaction structures.

Ratchet structures are sometimes used by private equity investors to bridge management's more optimistic performance forecasts and private equity's more conservative projections. These arrangements can take various forms. In one form, if the target company cannot meet the agreed post-closing performance targets within a certain period of time, the investor will have the option to be compensated in cash (claw-back of part of the purchase price) or to sell all or part of the equity in the target company back to the original seller based on an agreed formula.

In recent years, private equity investors have also adopted ratchet arrangements in transactions taking place in China. There is no specific law or regulation in China that provides explicit guidelines on the validity of ratchet arrangements, but two court rulings shed more light on this issue. The first ruling is *Haifu Investment Co., Ltd. v Gansu Shiheng Nonferrous Resources Recycle Company Limited* delivered by the Supreme People's Court of China in 2012. This ruling related to the validity of a purchase price claw-back. The second ruling in *Shanghai Winfine Equity Partnership v Lianyungang Dingfa Investment Co., Ltd. and Zhu Liqi* was issued by the Shanghai No.1 Intermediate People's Court in 2014 and related to the investor's put option to sell its equity back to the original seller.

Key considerations arising from the two rulings are:

- A ratchet arrangement will only be deemed valid if it is concluded between the buyer and the seller. A ratchet arrangement between the buyer and the target company is invalid.
- A ratchet arrangement can be in the form of cash compensation (claw-back of part of the purchase price) or a put option to sell equity back to the original seller.
- It is advisable to include the ratchet arrangement in an agreement with all target company shareholders, even if the arrangement only applies to some of the shareholders.

Certain transactions in China, such as foreign or state-ownership transactions, have to be approved by or filed with governmental authorities. We believe that the ratchet structure's approval or clearance of the ratchet structure by relevant governmental authorities will be a key factor for courts in deciding whether to confirm the validity of a disputed structure. Local level authorities especially may not be so familiar with sophisticated transaction structures and there is therefore always the risk that they may withhold approval or acceptance of the filing.

If the execution of a ratchet arrangement requires that cash flow in or out of China, the payment has to be registered with the State Administration for Foreign Exchange (SAFE). In practice, SAFE or the payment bank may challenge the basis of the payment, in which case the underlying transaction documents, the tax clearance certificate and other relevant evidence may be requested to facilitate the cross-border payment.

Even though the two court rulings do not provide conclusive guidance, we hope that they contribute to a general acceptance in China of alternative transaction structures providing buyers and sellers with more flexibility.