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SPC's New Ruling on Value Adjustment Mechanism urges Improvement of Private Equity Regulation

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In China, the 12th National People's Congress has just closed its first session on March 17, 2013. The call for reform of company law is one of the highlights at the Congress session. As part of the background hereof, the Supreme People's Court ("SPC") recently made for the first time a ruling on the so-called Value Adjustment Mechanism ("VAM") in private equity ("PE") transaction, which again pushes the debate over the deficiency of Chinese corporate regime.

Value Adjustment Mechanism in Private Equity Transaction

A VAM generally refers to a contractual arrangement upon which a PE investor makes investment in a target company while certain adjustments shall be made to the value arrangement of equity interests between the PE investors and the original shareholders, if the target company achieves or fails to achieve the specified business performance goals. For instance, in case of underperformance the controlling shareholders shall compensate the PE investor in cash or transfer certain portion of equity interests to the PE investor.

Case Study: *Haifu v. Shiheng*

While the VAM is regarded in the most countries as legitimate, its application in China has been controversial. In 2007, Haifu Investment Co., Ltd. ("**Haifu**" or the "PE Investor") entered into a capital increase agreement with Gansu Shiheng Nonferrous Resources Recycle Company Limited ("**Shiheng**" or the "**Target Company**") and Wisdom Asia Limited (the "**Controlling Shareholder**" of Shiheng). According to the VAM clause in the capital increase agreement, Haifu is entitled to a cash compensation if Shiheng's net profit for 2008 amounts to less than of RMB 30 million. If Shiheng fails to pay cash compensation to Haifu, Wisdom Asia Limited as the Controlling Shareholder shall pay this cash compensation to Haifu. The actual net profit in 2008 of Shiheng was disappointing and Shiheng failed to pay the stipulated cash compensation to Haifu; Haifu then filed an action against the Tar-

get Company and the Controlling Shareholder to seek enforcement of the VAM clause.

SPC's Ruling: A Separating Approach

The case *Haifu v. Shiheng* went through the first instance and the court of appeal, both of the courts held the VAM clause invalid, however on different grounds. By the retrial, the SPC approached the issues in a different manner and separately analysed the claim of the PE Investor as shareholder against the Target Company and the PE Investor's claim against the Controlling Shareholder. As regards the claim against the Target Company, the SPC found that the PE Investor would secure under the VAM clause a relatively fixed return on its investment regardless of the actual operation results of the Target Company. According to the SPC's opinion, such contractual arrangement between shareholder and company is against the principles of Company Law and the provisions in the Law on Sino-Foreign Equity Joint Venture. Therefore, this claim is to be rejected. As regards the claim against the Controlling Shareholder, the SPC held that the obligation of the Controlling Shareholder to compensate the PE Investor will not damage the interests of the Target Company and does not contravene any laws or regulations. Therefore, this claim under the VAM clause is valid and enforceable.

China's current corporate regime, in particular the laws on foreign investment which were largely enacted in the early 1980s, is not entirely compatible with the fundamental nature of PE investments in the current economy. In the case *Haifu v. Shiheng*, the SPC has made to some extent advance in clarification of the legitimacy of VAM, but failed to give a thorough interpretation of VAM under the current corporate regime.

Reference for Practice

Nevertheless, the significant reference for domestic and overseas PE investors can be achieved out of this SPC's ruling. For instance, it is advisable for PE investors to enter into a VAM clause with the original shareholders, in particular the controlling shareholder of the target company, or even the management team of the target company, instead of with the target company itself.

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