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PRC COURT CHALLENGES NET PROFIT GUARANTEE ARRANGEMENT

A recent high-profile PRC case calls into question the enforceability of an arrangement where cash "compensation" to a financial investor from a portfolio company would be triggered if the company fails to achieve a certain net profit target. Investors should be aware of this development and structure their incentive and downside protection arrangements with extra caution.

Private equity and venture capital funds often propose various arrangements that are intended to incentivize portfolio companies and their management to achieve specific operations and financial results, capture upside reward and protect against downside risks. *Haifu v. Gansu Shiheng*, pending before the Supreme People's Court of the People's Republic of China, calls into question the enforceability of one form of such arrangements where cash "compensation" to a financial investor from its portfolio company would be triggered if the company fails to achieve a certain net profit target. While the case is still pending and its exact impact remains to be seen, investors should be aware of this development and structure their incentive and downside protection arrangements with extra caution.

The key facts, as outlined in the written judgment issued by the High People's Court of Gansu Province, are summarized below.

In 2007, Chinese VC investor Suzhou Industrial Park Haifu Investment (Haifu) invested RMB20 million in Gansu Shiheng, a foreign-invested company based in Gansu Province (the Company). Of the RMB20 million total investment, RMB1,147,717 went into the Company's registered capital, representing a 3.85% equity interest in the Company; the remaining RMB18,852,283, 94% of Haifu's total investment in the Company, was recorded as capital surplus.

The investment agreement between Haifu and the Company contains the following provision: The Company's net profit in 2008 shall not be less than RMB30,000,000. If the Company's 2008 actual net profit is less than the target amount, Haifu shall have the right to demand "compensation" from the Company, in an amount equal to (1-2008 actual NP / 30,000,000) x 20,000,000; in the event that the Company fails to fulfill the obligation, Haifu shall have the right to demand such "compensation" from the Hong Kong parent that holds most of the equity interest in the Company.

It turned out that the Company made almost no net profit in 2008. Relying on the above net profit requirement provision, Haifu then demanded compensation from the Company and the Hong Kong parent in an amount equal to nearly its entire RMB20,000,000 investment amount.

The Intermediate People's Court of Lanzhou found that the net profit requirement provision violates the profit distribution provision of the Sino-Foreign Equity Joint Venture Enterprise Law (the EJV Law), which requires profit distribution to each joint venture partner in proportion to such partner's registered capital contribution. The Court deems the "compensation" scheme under the net profit requirement provision as a distribution of the net profit of the Company to Haifu disproportionate to, and higher than, its registered capital contribution, in violation of the EJV Law and thus invalid. The Court recognized and treated Haifu's entire RMB20,000,000 funding as an equity investment. Consequently, the Court dismissed Haifu's claim for compensation and Haifu appealed to the High People's Court of Gansu Province.

The Provincial High Court also found the net profit requirement provision to be invalid, though not because it shared the lower court's belief that such provision violates the profit distribution provision of the EJV Law. Instead, citing doctrine that investors should share their investment risk, which appears to be a general business principle rather than a statutory provision, the Provincial High Court held that the net profit requirement provision is invalid. This interesting reasoning laid the groundwork for the court to rule as it may have really intended. Citing an antiquated judicial interpretation of the adjudication of joint cooperation contract disputes, the Provincial High Court held that the RMB18,852,283 capital surplus portion of Haifu's funding was not equity investment, but should be characterized as a loan to the Company, and ordered that the Company and the Hong Kong Parent return such loan to Haifu, together with interest accrued at the term deposit rate. In essence, Haifu lost its contract-based claim, but won the case nonetheless.

The Company has since appealed to the Supreme People's Court at the national level, which accepted the case and commenced retrial. The Supreme People's Court only accepts cases for retrial if it believes, based on its preliminary review, that there may have been mistakes or flaws in the fact finding, application of law or procedural matters in the original proceeding. Depending on its finding, the Court may affirm, reverse, vacate or amend the decision of the Provincial High Court.

Although court decisions in China do not technically have precedential value as in common-law countries, business and legal communities in China are still closely watching further development of this case. The ultimate outcome of this case will signal the attitude of Chinese courts towards the kind of net profit requirement provision in such cases. It may even have a broader impact on other types of incentive and downside protection arrangements. Private equity and venture capital investors that are accustomed to such arrangements should take note that both the intermediate court in Lanzhou and the Provincial High Court challenged and invalidated the type of net profit requirement arrangement adopted in this case, even though they applied different theories leading to drastically different outcomes.

Another common concern, which unfortunately is reinforced by this case, is immaturity and lack of clarity in Chinese law, creating unpredictability in Chinese legal proceedings. As a result, many non-PRC private equity and venture capital funds may wish to continue the practice of implementing incentive and downside protection arrangements through offshore holding vehicles that own Chinese operating companies, thereby avoiding the uncertainty of validation and enforceability of such arrangements in Chinese courts. Most mature offshore jurisdictions still offer greater flexibility and predictability. If an offshore arrangement is not feasible, then investors should be careful in structuring these incentive and downside protection arrangements to ensure their enforceability. For example, the downside protection may need to be provided by founders or other shareholders of the portfolio company rather than by the company itself. If, for any reason, the downside protection must come from the portfolio company, the funding could, through careful planning, be structured as a loan which would be repaid or converted into equity, depending on whether the target is met. Another alternative is to structure the portfolio company as a joint stock company which is allowed to adopt a disproportionate profit distribution scheme.

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