

PRIVATE EQUITY IN CHINA: ENFORCEABILITY OF DRAG-ALONG RIGHTS

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Introduction

Notwithstanding the current credit crisis and general global economic downturn, private equity in China continues to attract attention across the private equity spectrum from global and regional funds and other investors. Three factors can be attributed to the continuing success of private equity funds in China:

- 1) the continued growth of China's economy despite a global downturn (8 percent growth target for 2009);
- 2) the increasing global competitiveness of local Chinese companies that desire expertise and capital to expand internationally; and
- 3) the shortage and unavailability of financing from local Chinese banks.

While significant business opportunities in China remain, private equity firms also face issues that are unique to China transactions. Culturally, most local Chinese business people are unfamiliar with modern corporate governance and management practice. Additionally, an underdeveloped legal system remains a continuing challenge for most private equity firms. By way of example, China did not have a limited liability company (LLC) concept similar to a Delaware LLC until 2006; similarly China did not have a limited liability partnership law, which is common place in private equity structures, until June 2007. Traditional concepts common in a Western private equity context—such as preferred shares, convertible shares, anti-dilution, drag-along and tag-along rights—are still unfamiliar under current Chinese law. Under many private equity investment contracts, these concepts have been widely negotiated and adopted, but whether

such concepts will be enforced under Chinese law remains uncertain.

Lawsuit

In early 2008, Chunsheng Lu, an associate in the Firm's Business Department, participated in a lawsuit initiated to enforce a drag-along clause under a private equity investment agreement. Prior to this lawsuit, which was tried in a local Shanghai court, there is no public record of any Chinese court addressing the enforceability of drag-along rights under Chinese law.

The suit involved a Hong Kong-based private equity firm that invested in a local Shanghai company and obtained a majority equity interest. Under the shareholders agreement for the Shanghai company, a drag-along clause was included which gave the majority shareholder, the Hong Kong firm, the right to force the minority shareholder (the original shareholder of the local Shanghai company) to join in the sale of the company to a third-party buyer with the same price, terms and conditions that would apply to the majority shareholder. When the Hong Kong firm received an offer to buy the total equity interest of the company from a third-party buyer, it decided to sell the company and exercise the drag-along right as provided in the contract. The minority shareholder refused to sell its shares, arguing that such drag-along rights were unfair, not recognized under Chinese law, ambiguous and therefore, not enforceable.

White and Williams assisted our Shanghai-based strategic alliance partner firm, the Xue Firm, in representing the Hong Kong firm and brought the suit before the Shanghai court in March 2008. The

Hong Kong firm petitioned the court to grant performance. But due to the concern over possible time delay and uncertainty of the validity of the intended transaction, the third party withdrew the offer. The Hong Kong firm then amended the claim to seek, among other things, monetary compensation from the minority shareholder for the loss of the economic benefit from the proposed transaction and declaratory judgment.

In June 2008, before the Shanghai court made its final decision, the underlying legal issues in the lawsuit were presented, on an anonymous basis, to the attendees of the second China International Private Equity Forum in Tianjin (CIPEFT). CIPEFT is viewed in China as the premier private equity event for China-based private equity, attended by in excess of 1000 private equity investors and professionals. The presentation in June 2008 at CIPEFT was received by a high level of interest from the private equity investor community, many of whom communicated that the result of the lawsuit would be an indicator of the maturity level of China's private equity investment environment.

At the end of October 2008, after a lengthy trial, the Shanghai court recommended a settlement between the parties and the parties complied. In doing so, the court implicitly adopted the position that the drag-along right should be enforceable notwithstanding the fact that such a concept had not been expressly stated in any Chinese laws. During the trial, the minority shareholder's counsel vigorously argued that the drag-along clause is inherently unfair but the judge, while not rendering a definitive opinion, rejected such argument by stating the fact that the same price, terms and conditions would be applicable to both the majority shareholder and the minority shareholder and, therefore, he could not discern any unfairness in the agreement.

Ultimately, the parties settled the dispute by agreeing that the minority shareholder would transfer all of its equity to the Hong Kong firm at the same price and with the same terms offered by the original third-party buyer, less any legal fees that the Hong Kong firm incurred in connection with this lawsuit.

While this result did not give rise to a final written opinion by the Shanghai court on the enforceability of the drag-along right, the Hong Kong firm did obtain the ultimate protection contemplated under a drag-along clause. Further, the court's recommended settlement is a strong indication that the Shanghai courts are in favor of the "free-contracting" approach consistent with traditional private equity investment agreements as long as a contract is not patently unfair.

Conclusion

As China's legal and economic framework continue to mature, we believe traditional western private equity concepts will become more common place. Many also believe that China will continue to develop law and business practices on private equity more consistent with international standards. Understanding the evolving legal framework of China is of critical importance to appropriately document private equity transactions with China-based companies.

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