Pre-emptive Rights of PE Investors under Chinese Law

A succinct summary jointly by Mary Zhu and Prof Peter Koh

Private Equity investment ("PE investment") refers to an equity investment in non-public listed companies by investing institutions (usually set up as limited partnerships in BVI and other financial centres) which raise money from individuals and entities for specific commercial objectives.

High returns and a quitting mechanism are the main focus of PE investment in the People's Republic of China ("PRC").

Accordingly, in order to protect its interests, a PE investment institution as the investor, when making investment in a company ("Target Company"), and the original shareholders of Target Company will have to agree on some special rights to be given to the PE investor. They are the pre-emptive rights of PE investors.

Generally, the pre-emptive rights of the PE investor are realized through the convertible preferred stocks issued by Target Company, and are agreed on in the investment agreement and the amendments to the articles of association of Target Company.

Undoubtedly the Chinese law is the applicable law for the financing via private equity investment to the enterprises in China. Currently there is no specific by-law regulating the private equity investment. Besides, PRC Company Law is silent on the preferred stocks.

For issues relating to the pre-emptive rights of PE investors, the terms in the investment agreement must not be in conflict with the existing laws and regulations of China. At the same time, adequate communication with the competent administrative departments and registration departments is required.

Dividends Preference

Dividends preference refers to the PE investor's pre-emptive right to the allocation of dividend which equals to certain percentage of its investment amount when Target Company allocates dividends to shareholders. After PE investor receives such pre-emptive dividend, the PE investor either 1) is no longer entitled to the residual dividends; or 2) continues to get a part from the remaining dividends together with other shareholders pro-rated to their respective investment./capital contributions.

Under Article 35 of the Company Law, shareholders shall be given dividends pro-rated to their capital contributions. However, there can be an exception to this cardinal rule. They can unanimously agree to no-receipt of the dividends.

Article 35 is commonly interpreted as shareholders being allowed to have their own agreement on the percentage but not the timing of the dividend distribution. In that case, shareholders need to agree inter se to such an arrangement in their investment or shareholders' agreement.

For instance, they can agree that if the distributable dividends do not reach N% of the PE investment, only the PE investor is entitled to the dividends. When the distributable dividends exceed N% of the PE investment all other shareholders, together with the PE investor, will be entitled to dividends based on their pro-rated capital/investment investment.

Further, according to Article 4 of the Law of the PRC on Chinese-Foreign Equity Joint Venture, the parties to the venture shall share the profits, risks and losses in proportion to their respective contributions to the registered capital. Therefore, dividends preference of PE investor is not applicable to the Chinese-foreign equity joint ventures.

Liquidation Preference

Liquidation preference means that, upon liquidation of Target Company, the PE investor is entitled to be given priority over the distribution of net assets after payment of all debts. The PE investor will be paid an amount which equals to its original investment contribution plus certain returns.

The proceeds from realization of the assets after distribution to the PE investor can be again distributed in the following two ways: 1) shareholders other than the PE investor based on their pro-rated investment/capital contributions; or 2) all shareholders including the PE investor based on their respective investment /capital contributions.

In accordance with Article 187 of the PRC Company Law, the net proceeds from disposal of the assets and after payment of all debts, in the case of a limited liability company, can be distributed according to the shareholders' capital contribution. In the case of a joint stock limited company, the proceeds can be distributed according to the proportion of stocks held by the shareholders.

In accordance with Article 23 of the to the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures, the Chinese and foreign parties shall, in accordance with the agreement specified in the contractual joint venture contract, determine the ownership of the venture's property in the case of the liquidation.

In accordance with Article 94 of the Regulations for the Implementation of the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures, the remaining property after the clearance of debts shall be distributed among parties to the joint venture according to the proportion of each party's investment unless otherwise provided by agreement, contract and articles of association of the joint venture.

Therefore, in principle the liquidation preference is applicable to the Chinese-foreign equity joint venture and Chinese-foreign contractual joint venture. When Target Company is a domestic company with limited liability, generally the liquidation preference will be specified in the investment agreement or the shareholders' agreement as an internal agreement among the shareholders.

Pre-emptive Right to Subscription of New Shares and Right of First Refusal

Pre-emptive right to subscription to new shares means that the PE investor has the pre-emptive right to subscribe to the new shares issued by Target Company based on its shareholding percentage.

The rationale for this is to prevent a dilution of the share holding of the PE investor.

Right of First Refusal means the PE investor has the pre-emptive right to, other things equal, purchase the shares transferred by other shareholders of Target Company.

Under Article 35 and Article 72 of the PRC Company Law, when a company is going to increase its capital, its shareholders have the preemptive right to subscribe to the new shares based on the same percentage of their original capital contributions. The same principle applies to pre-emptive rights of stock rights.

Therefore, both the pre-emptive right to subscription of new shares and the right of first refusal are legally feasible and applicable under Chinese law.

Redemption Right

Redemption right means that, under certain circumstances (commonly Target Company fails to complete the listing arrangement as scheduled or other shareholders fail to comply with the investment agreements), the PE investor requests Target Company or other shareholders to buy back the equity held by the PE investor.

Based on Article 75 of the Company Law, the circumstances under which a shareholder can request a company to buy back equity are as follows:

(1)The company is profitable for five consecutive years and has failed to distribute any dividends to the shareholders for the same period and conform to the profit distribution conditions as prescribed in this Law;

(2)The company is the subject of a merger or to be split up, or transfer the major properties of the company to others;

(3)When the business term as specified in the bylaw expires or other reasons for dissolution as prescribed has taken place, the shareholders' meeting passes a resolution to circumvent the by-law.

Tag along

PE investor has the right to join in a transaction where other shareholders of Target Company transfer their shares to a third party. The PE investor has the right to do likewise pro-rated to its investment figure. Tag along is a common M & A lexicon and it is part of an internal agreement among shareholders to the disposal of shares, which is not prohibited under Chinese law. Such a right is feasible and applicable under Chinese law.

Veto Right

Veto right means the PE investor and the directors appointed by the PE investor are entitled to exercise veto right on certain major issues of Target Company. The PRC Company Law specifies the powers and functions of board of directors and shareholders, and at the same time allows the articles of association of a company to provide other powers and functions not mentioned in the law. Therefore, Target Company's articles of association can provide the veto right for the PE investor or the directors appointed by the PE investor on several matters. Consequently, veto right is feasible and applicable under Chinese law.

Conclusion

In summary, PE investor is different from general shareholders in that PE investor is entitled to several pre-emptive rights, which is actually closely related to the risks involved in PE investment. From a practical perspective, PE investor needs to fully understand the mechanics of the pre-emptive rights and consider the risk factors involved in the relevant application formalities with relevant administrative authorities.