Defending foreign PE investments

China has become one of the most attractive markets for private equity firms. But when problems occur, what options do investors have to enforce their rights?

Foreign investors are pouring into China seeking opportunities to invest and get favourable returns. The supply of investors far outweighs the number of deals. This high pressure environment can lead to problems with investments.

A private equity investment in China involves foreign investors buying into a Cayman or British Virgin Islands (BVI) company, specifically incorporated for the purpose of the investment. Through a chain of wholly owned subsidiaries, the Cayman or BVI company controls the Chinese operating company by a controlling stake or controlling contracts. The length of the chain varies and typically comprises one or more offshore company, one or more Hong Kong company and a wholly foreign-owned enterprise (WFOE) in mainland China. All of these are shell companies for holding purposes.

Foreign investors rely on a series of contracts to protect their investment. The founders of the operating company, the management team and the chain of companies, all receive the investment and are contractually liable under certain circumstances.

Transaction lawyers ensure the sophisticated structure of the investment and that investors are protected. However, problems arise when investors seek legal advice to resolve a disagreement with the operating companies. Dispute resolution lawyers enter the mix and they often do not share the same opinions as transaction lawyers regarding the protection mechanism.

Enforcement difficulties

A common situation when an investment goes wrong occurs when the actual controllers of the operating company and their related parties steal money through unlawful transactions. Foreign investors have few choices to protect themselves. They can choose to place pressure on the offenders and force them to correct the misconduct, or initiate legal proceedings to recover loses. Neither of these options usually works due to multiple impediments.

Jurisdiction

With enforcable claims in the right jurisidiction, the investment remains curable if the investor possesses the necessary advantage to put pressure on the opponent through legal proceedings. This slight advantage is not pleasant, but can prevent the actual controllers from additional misconduct. In certain cases it leads to the investors retrieving all of their money.

This kind of advantage is not always available to investors because of the selection of jurisdiction. US investors serve as an example; they almost always choose a US court as exclusive jurisdiction. It may be understandable, but by no means advisable. If the operating company no longer engages in negotiations, investors can only turn to their selected jurisdiction for justice. Investors believe that by initiating legal actions they have some leverage over the controlling company.

The offending parties have no reason to give in to this leverage, as legal actions in the US have no repercussions as long as they have no assets in the US and do not plan on visiting. It is useless for investors to obtain a default judgment. A US judgement is almost impossible to get enforced in China. Several cases show that there is little advantage gained from filing or threating legal actions in overseas jurisdictions.

Applicable law

As is the case with jurisdictional selection, foreign investors tend to choose their local laws as governing law. This makes it even harder for them to enforce their rights in China. Pursuant to Article 126 of the *PRC Contract Law* (中华人民共和国合同法), "the parties to a contract involving foreign interests may choose the law applicable to the settlement of their contract disputes, except as otherwise stipulated by law". While The Supreme People's Court's Interpretation on the Implementation of the General Principles of Civil Law, states in case of an act of evading the mandatory or prohibitive legal norms of China by a party, the law of any foreign country shall not apply. Investors remain safe if no terms or provisions in the transaction documents circumvent mandatory law or prohibitive rules of China.

In order to reinforce the protection mechanism, investors often require a guarantee from the operating company, its founders and the management team. This makes them liable under certain situations as guarantors. As the guarantors are Chinese residents and the guaranteed party are foreigners, the guarantee involves foreign interests and is subject to mandatory examination and approval or recordation by the State Administration of Foreign Exchange (SAFE). SAFE does not approve or record the foreign guarantee, which makes this guarantee invalid pursuant to Chinese law. Foreign laws also do not apply here, even if the parties have selected foreign laws as the exclusive governing law. Selection of foreign laws is invalid as they evade mandatory PRC laws and rules. It is common that in litigation cases, guarantees involving foreign interests are held invalid and the selected foreign laws do not apply. Thus investors cannot hold the guarantors liable under guarantee, even if they have obtained an effective and favourable judgment of a guarantee from a foreign jurisdiction.

Cause of action

Upon realising that foreign legal actions cannot gain leverage, investors turn to legal action in China. Foreign investors do not have direct interest in the operating company in China, except in the transaction contracts. Breach of contract is no longer a viable cause of action because of the jurisdictional selection. Investors have to consider alternative approaches, such as litigation based on tort. Investors now think they are close to success, as someone has to be held liable under at least Chinese law.

Recent cases show that misconduct usually occurs in the operating company where the investor's money finally ends up and to which the money belongs, making it the direct victim. According to Chinese law, when the operating company's interest is damaged, it is up to the company to pursue legal action. With no direct stake in the operating company, investors cannot be a plaintiff and bring legal action. They can enforce their rights by imposing influence on the subsidiaries, but this is impractical if they are only a shareholder of the offshore company.

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Enforcing foreign decisions

If investors do obtain an effective foreign judgment or arbitration award, that judgment or award still has to be recognised and enforced by a Chinese court. China is a member state of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Under this convention Chinese courts must review, recognise and enforce arbitration awards from other member states, except if in violation of Chinese law or other discrepancies not acceptable by Chinese courts. Compared with arbitration awards, foreign judgments have little chance of being recognised or enforced by Chinese courts unless there is a bilateral agreement between China and the foreign jurisdiction concerned. Investors have to file with a Chinese court for recognition of their judgments or awards anyway and the process is time and cost consuming.

Possible solutions

When an investment is already jeopardised, almost no effective legal solution exists to directly return the money. Pressure can still be leveraged on the offenders through an action of revocation of unlawful internal transactions as an interested party. If an investor is still negotiating its deal, consider the following approaches maximising their ability to enforce their rights in China.

Choose China

The simplest and most effective solution is selecting China as one of the jurisdictions. It does not have to be an exclusive jurisdiction, rather only under certain circumstances. It is inexplicable that foreign investors are willing to invest large amounts of money to a Chinese company controlled by people they are not familiar with and not trust the laws and legal system of China where their money ends up.

Alternatively, investors can choose Hong Kong as one of the jurisdictions, which makes enforcement possible. The Arrangement of the Supreme People's Court between the mainland and the HKSAR on Reciprocal Recognition and Enforcement of the Decisions of Civil and Commercial Cases under Consensual Jurisdiction enables investors to apply for recognition and enforcement of Hong Kong judicial judgments in mainland China.

Control the plaintiffs

Disliking China as a jurisdiction may be understandable, but investors can control eligible plaintiffs and take legal action in the name of those plaintiffs. If misconduct occurs, the company can file legal proceedings against the offenders. In practice, the offenders control the operating company, leaving the sole supervisor or the shareholder the only choice for the investors to initiate action.

Investors have a choice when negotiating the action. Instead of establishing a board of supervisors, they can designate a sole supervisor of the operating company. If the actual controller engages in misconduct, the sole supervisor, under the investor's instruction, can lodge a lawsuit. Investors can also acquire actual control of the WFOE's shareholder (usually a shell company incorporated in Hong Kong) who may also be eligible to lodge a lawsuit against the offenders on behalf of the WFOE.

Exploit indolence

If China is not selected as the competent jurisdiction, investors can hardly enforce their rights, as they do not possess direct interests in the operating company. Subrogation can help investors solve this problem. The *PRC Contract Law* stipulates that if the obligor is indolent in exercising its due creditor's right, thus damaging the interests of the obliged, the obliged may request the People's Court for subrogation in its own name.

The investors are creditors to the transaction contracts if a breach of contract occurs by the other parties. When drafting the transaction documents, the investors, the operating company and the actual controllers, under specific circumstances, can deem the operating company indolent in exercising its due creditor's right. This entitles the investors to pursue the operating company's obligor for subrogation. The arrangement enables the investors to enforce their rights and makes it harder for the operating company to consider offending.

Get the wording right

SAFE's inability to validate guarantees for foreign interests does not hinder investors from enforcing their rights as long as the wording in the transaction contract is correct. According to the *PRC Security Law* (中华人民共和国担保法), if a guarantee contract is held null and void, the debtor and/or the guarantor in fault are liable to compensate the investor, not under guarantee, but under tort law. This is enforceable if the investors can prove the debtor and the guarantor's liability resulting in an invalid guarantee contract

Solving the problem early

Involve litigators before the execution of contracts to evaluate the enforceability and to provide practical solutions highlighting any problems early on. Experienced litigators are helpful when problems arise, but they are even more capable in identifying practical difficulties for investors, especially when enforcing their rights and can even provide pragmatic solutions beforehand. Investors often disregard enforceability, but this is the biggest incentive to potential offenders. Investors can eliminate this potential by ensuring possible legal actions and understanding how to enforce their rights.

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