

THE ENFORCEABILITY OF ANTI-DILUTION PROVISIONS IN PRIVATE PLACEMENT TRANSACTIONS IN CHINA

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Table of Contents

I. INTRODUCTION	46
II. TYPICAL ANTI-DILUTION PROVISIONS IN THE WESTERN CONTEXT	47
A. Structural Changes in Common Stock	48
B. Cheap Issuance of Common Stock	48
C. Distribution of Cash or Property	51
III. POPULAR ANTI-DILUTION PROVISIONS USED IN CHINA	51
A. BOCOM-HSBC Deal	52
B. DGME-CBF Deal	54
C. ABC-SSF Deal	54
D. CUT-TCPE Deal	55
E. LXC-DLC Deal	56
F. ICBC-Investors Deal	56
IV. VALIDITY AND ENFORCEABILITY OF ANTI-DILUTION PROVISIONS UNDER PRC LAW	57
A. Percentage Maintenance Provisions	58
B. Down Round Prohibition Provisions	60
C. Down Round Adjustment Provisions	60
V. CONCLUSION	62

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I. INTRODUCTION

Anti-dilution provisions are complex.¹ In the Western legal context, “anti-dilution provisions are designed to protect holders of convertible securities² against dilution from a large variety of corporate events, including, among others, stock dividends and splits, cheap issuance of additional common stock, and distribution of cash or property.”³ The benefit of anti-dilution adjustments made under these provisions is that one of the preferential rights may be carried by preferred shares, which are “an integral part of the package of privileges investors demand and founder shareholders offer.”⁴ Therefore, the execution and enforcement of anti-dilution provisions rely theoretically on a corporate legal regime that is capable of accommodating the issuance of preferred shares.

To date, no Chinese⁵ legislative document, judicial interpretation or court ruling⁶ has provided explicit guidance on how a company could issue multiple classes of shares, including preferred shares, to different groups of shareholders.⁷ The concept of anti-dilution

¹ See, e.g., Stanley A. Kaplan, *Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities*, 33 U. CHI. L. REV. 1, 3 (1965); Michael A. Woronoff & Jonathan A. Rosen, *Understanding Anti-dilution Provisions in Convertible Securities*, 74 FORDHAM L. REV. 129, 129–30 (2005).

² *Convertible Securities*, US SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/answers/convertibles.htm> (last visited Jan. 30, 2013) (defining a “convertible security” as a security, usually a bond or a preferred stock, that can be converted into a different security, typically shares of the company’s common stock).

³ Woronoff & Rosen, *supra* note 1, at 129.

⁴ Shen Wei, *Face Off: Is China a Preferred Regime for International Private Equity Investments? Decoding a “China Myth” from the Chinese Company Law Perspective*, 26 CONN. J. INT’L L. 89, 96 (2010–2011) (“Preferred shares carry preferential rights that are an integral part of the package of privileges investors demand and founder shareholders offer.”).

⁵ For the purpose of this article, Chinese and China refer to the People’s Republic of China, excluding Hong Kong, Macau and Taiwan.

⁶ Judicial precedents are not enforceable in China. The Supreme People’s Court, however, has the authority to issue judicial interpretations as guidelines to trials, which are nationally enforceable. *Legal Research Guide: China*, UNITED STATES LIBRARY OF CONGRESS, <http://www.loc.gov/law/help/china.php> (last visited Jan. 30, 2013).

⁷ See, e.g., Shen, *supra* note 4, at 98 (“Although the basic legal interpretation doctrine does not preclude the possibility of adopting a multiple-class share structure in a limited liability company, no Chinese legislation has actually provided explicit guidance over how a company may issue multiple classes of shares to different groups of shareholders.”).

provisions, common in the Western legal context, thus remains unfamiliar and largely without a secure legal foundation in Chinese law.⁸

However, anti-dilution provisions have been negotiated and adopted by founder shareholders and investors in many private placement⁹ transactions in China. This is especially frequent when the investor is a foreigner who is familiar with anti-dilution provisions.¹⁰ Yet the lack of a secure legal foundation for these provisions casts considerable doubt on their enforceability.¹¹

This article is divided into four parts. Part I describes typical anti-dilution provisions in the Western private placement context. Part II examines the most popular anti-dilution provisions used in China and considers several high-profile deals. Part III analyzes the validity and enforceability of anti-dilution provisions under PRC law. Part IV concludes by proposing several courses of action to minimize the uncertainty of enforcing anti-dilution provisions in China.

II. TYPICAL ANTI-DILUTION PROVISIONS IN THE WESTERN CONTEXT

As Michael Woronoff and Jonathan Rosen note, “[t]o understand different types of anti-dilution provisions, it is important to examine the nature of the dilution against which each provision is designed to protect.”¹² There are two types of dilution. Percentage dilution refers to a decrease in the percentage of the entity an investor owns. Economic dilution refers to a decrease in the economic value of the investor’s investment in the entity.¹³ Typically, a simple percentage

⁸ See Chunsheng (Tony) Lu & Gary P. Biehn, *Private Equity in China: Enforceability of Drag-Along Rights*, WHITE AND WILLIAMS LLP (Jul. 17, 2009), <http://www.whiteandwilliams.com/resources-alerts-86.html> (“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.”).

⁹ For the purpose of this article, private placement refers to non-public offerings or sales of shares in a closed company incorporated in China. Anti-dilution provisions used in private placements of companies outside China governed by foreign laws are not discussed in this article.

¹⁰ In many high-profile private placement transactions in China, anti-dilution provisions have been adopted, such as the BOCOM-HSBC Deal and DGME-CBF Deal. For more detailed discussion of this topic, see *infra* Part II.

¹¹ See, e.g., Lu & Biehn, *supra* note 8 (“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.”).

¹² Woronoff & Rosen, *supra* note 1, at 134.

¹³ *Id.*

dilution will not trigger dilution protection. Only economic dilution is dealt with in anti-dilution provisions.¹⁴

Many actions can have a dilutive effect on outstanding convertible securities.¹⁵ Anti-dilution protection will be triggered in a number of situations, such as share splits, sales of common stock below the specified conversion price, distributions of stock dividends, extraordinary dividends, issuance of options, and corporate mergers or consolidations.¹⁶ The most common situations are (i) structural changes in common stock, (ii) cheap issuance of common stock, and (iii) distribution of cash or property.¹⁷

A. Structural Changes in Common Stock

Structural changes in the common stock of a company, such as stock dividends, stock splits, or similar recapitalization, are generally intended to restructure the company's capital framework, not fundamentally alter the company's assets or the owners' equity.¹⁸ To protect convertible security holders from economic dilution, lawyers generally adopt a clause adjusting the conversion price of the convertible security to ensure that investors maintain the same percentage ownership before and after the changes.¹⁹

B. Cheap Issuance of Common Stock

Anti-dilution provisions may be triggered when there is a sale of common stock below a specified price. This "cheap issuance" may economically dilute the initial investment if additional shares are issued at below the initial conversion price. The cheap issuance may also dilute the current value, if additional shares are issued below the current market price.²⁰

Both types of economic dilution can be cured by adjusting the conversion price of the initial investment. A "conversion-price formula" is triggered when additional shares of common stock are issued at a price below the original conversion price, and a "market-price formula" is triggered when these additional shares are sold at a price below their current market value.²¹ These formulas are

¹⁴ See David A. Broadwin, *An Introduction to Antidilution Provisions (Part I)*, PRAC. LAW., June 2004, at 30 ("A simple decline in percentage interest is dealt with in other contractual provisions such as rights of first refusal rather than antidilution provisions.").

¹⁵ Woronoff & Rosen, *supra* note 1, at 140.

¹⁶ See Kaplan, *supra* note 1, at 4–5.

¹⁷ See Woronoff & Rosen, *supra* note 1, at 140–41.

¹⁸ *Id.* at 142.

¹⁹ *Id.*

²⁰ *Id.* at 142–43.

²¹ *Id.* at 143, 150.

based on different underlying theories.²² The market-price formula is based on the concept that the holder of the convertible security is in the same position as a common stockholder, whereas the conversion-price formula is based on the idea that the holder of the convertible security is better off than a holder of common stock.

In practice, it is a challenge for privately-held companies or small and medium-sized publicly traded companies with a “thin market” to utilize the market-price formula, since it is not straightforward for them to identify their current market value efficiently.²³ Therefore, the conversion-price formula dominates in most convertible securities transactions.²⁴

A conversion-price formula generally takes two approaches: the full-ratchet approach or weighted-average approach.²⁵ The approach used can have significant economic consequences,²⁶ since the extent of adjustment will depend on the type of anti-dilution formula associated with the existing preferred stock.²⁷

The full-ratchet approach is the most “protective”²⁸ and “favored”²⁹ formula for investors.³⁰ Under the full-ratchet approach, the conversion price is reduced to the price adopted in the subsequent dilutive issuance. This places the existing stockholder in the position they would be in if they had purchased their shares of common stock at the new, lower price.³¹ The full-ratchet approach is rare,³² offering

²² See Kaplan, *supra* note 1, at 22 n.31.

²³ See *id.* at 23 (“Therefore, the market price clause will probably find little or no acceptance in the convertible securities issued by small or closed corporations or by corporations whose outstanding securities have a limited market.”).

²⁴ Broadwin, *supra* note 14, at 27 (“Experience indicates that most of the convertible securities issued by these companies have private company type antidilution provisions.”).

²⁵ See Woronoff & Rosen, *supra* note 1, at 145.

²⁶ *Id.*

²⁷ See Robert P. Bartlett, *Understanding Price-Based Antidilution Protection: Five Principles to Apply When Negotiating a Down-Round Financing*, 59 BUS. LAW, 23, 25 (2003).

²⁸ *Id.*

²⁹ Jerome S. Katzin, *Financial and Legal Problems in the Use of Convertible Securities*, 24 BUS. LAW, 359, 365 (1969).

³⁰ For instance, a founder shareholder owns 1,000 shares of common stock; investor A pays \$1,000 for 1,000 shares of series A preferred stock at a conversion rate of “converting 1 preferred stock into 1 common stock” with a conversion price of \$1 per share, and is entitled to full-ratchet anti-dilution protection. If investor B subsequently purchases 1,000 shares of series B preferred stock at the expense of \$500, investor A can adjust its original conversion rate into “converting 0.5 preferred stock into 1 common stock” and therefore double its shares by adopting the new conversion price of \$0.5 per share when converting the preferred stock into common stock.

³¹ See Woronoff & Rosen, *supra* note 1, at 145; see also Bartlett, *supra* note 27, at 25.

³² See, e.g., Scott Edward Walker, *Further Demystifying the VC Term Sheet*, VENTUREBEAT TECH. (Feb. 14, 2011), <http://venturebeat.com/2011/02/14/further-demystifying-the-vc-term-sheet>; see also *From the WSGR Database: Financing Trends for Q2 2012 and 1H 2012*, WILSONSONSINI GOODRICH & ROSATI CORPORATION HOMEPAGE, <http://www.wsg.com/publications/PDFSearch/entreport/1H2012>

strong protection to the investors while draconian to the founder and other holders of the company's common stock.³³

The weighted-average approach refers to a calculation of the weighted average price at which additional shares have been issued.³⁴ In addition to the "lower price," the weighted-average approach also considers "the number of the shares of stock issued at a lower price". Consequently, under the weighted-average approach, the greater the number of low-price shares, the greater the anti-dilution adjustment.³⁵ The typical formula for the weighted-average approach is illustrated below:³⁶

$$CP_1 = (CP_0 \times O_0 + \$) / (O_0 + I)$$

- CP_1 =adjusted conversion price
- CP_0 =initial conversion price
- O_0 =number of common shares outstanding (or deemed outstanding) prior to dilutive issuance
- $\$$ =consideration received for the issuance of dilutive securities
- I =number of common shares issued (or deemed issued) in the dilutive issuance

Depending on which shares are deemed outstanding (i.e. how to define O_0) the weighted-average approach can be carried out using the broad-based method or weighted-based method.³⁷ The broad-based method dominates in venture financing transactions, compared with the unpopular narrow-based method.³⁸ All common stock is considered outstanding under the broad-based method. This gives effect to the exercise or conversion of all outstanding warrants,

/private-company-financing-trends.htm (last visited Mar. 3, 2013) [hereinafter *WSGR Database*] ("The use of ratchet anti-dilution stayed level at 3% of financing in each of 1H 2012 and 2011.").

³³ Revisit the example discussed in *supra* note 30. If investor B merely purchases 1 share of series B preferred stock at a conversion price of \$0.5 per share, investor A still can adjust its original conversion price into \$0.5 per share and therefore double all of its shares.

³⁴ Broadwin, *supra* note 14, at 35.

³⁵ See Woronoff & Rosen, *supra* note 1, at 147.

³⁶ We return to the example discussed in *supra* note 30. If investor A is entitled to the weighted-average (instead of the full ratchet) anti-dilution protection, when investor B subsequently purchases 1,000 shares of series B preferred stock at the expense of \$500, investor A can adjust its original conversion price into $CP_1 = (CP_0 \times O_0 + \$) / (O_0 + I) = 1 \times 2000 + 500 / 2000 + 1000 = \0.83 per share. In other words, when converting preferred stock into common stock, the conversion rate applicable to investor A shall become "converting 0.83 preferred stock into 1 common stock."

³⁷ See Woronoff & Rosen, *supra* note 1, at 149.

³⁸ See *WSGR Database*, *supra* note 32 ("Broad-based weighted-average anti-dilution continued to be overwhelmingly prevalent, being used in 90% of 1H 2012 deals versus 91% of deals in each of 2010 and 2011 [. . .] Notably, the use of narrow-based weighted-average anti-dilution fell by half, from 4% of 2011 deals to 2% of those in 1H 2012.").

options, and convertible securities.³⁹ Only a subset of shares is deemed outstanding under the narrow-based method, such as the common stock issuable upon conversion of the particular series or all shares of preferred stock.⁴⁰

Since more outstanding shares prior to a dilutive issuance will result in less dilution, the common stock holder or founder shareholder will want to increase the number of outstanding shares. Conversely, the preferred stockholder or investor will want to decrease them.⁴¹ Therefore, from the perspective of a preferred stock investor, a full-ratchet approach is the most “favored” formula, a narrow-based weighted-average approach is less favorable, and a broad-based weighted-average approach is the worst.

C. Distribution of Cash or Property

If a company distributes cash or other properties to its common shareholders, percentage dilution will not occur. However, convertible security holders will suffer economic dilution. Such distribution transfers value from convertible security holders to common stock holders by siphoning off profit or assets of the company.⁴² To protect against this economic dilution, an anti-dilution provision is usually adopted to reduce the conversion price. This lets holders of convertible securities obtain additional shares equal in value to the losses per share caused by the dilutive distribution.⁴³ Of course, convertible security holders may avoid economic dilution by simply prohibiting the dilutive distribution.⁴⁴

III. POPULAR ANTI-DILUTION PROVISIONS USED IN CHINA

Anti-dilution provisions are widely used in China’s private placement transactions. At this point, this article examines and discusses several high-profile onshore private placement transactions governed by PRC law in which anti-dilution provisions were involved. Anti-dilution provisions used in China are different from those used in the West. All of these deals were performed by issuing

³⁹ See Woronoff & Rosen, *supra* note 1, at 149.

⁴⁰ Yokum, *What Is Weighted Average Anti-Dilution Protection?*, STARTUP COMPANY LAWYER.COM (Aug. 4, 2007), <http://www.startupcompanylawyer.com/2007/08/04/what-is-weighted-average-anti-dilution-protection/>.

⁴¹ Broadwin, *supra* note 14, at 36.

⁴² See Woronoff & Rosen, *supra* note 1, at 153.

⁴³ *Id.* at 153–54.

⁴⁴ *Id.*

common shares.⁴⁵ In most cases, the common shares were issued through capital increases by new investors.⁴⁶ In these deals, anti-dilution provisions were crafted to protect against percentage dilution and economic dilution. When dealing with economic dilution, some anti-dilution provisions directly impose obligations on the target company, while others are designed to chase after the founder shareholder. This difference may impact the enforceability of the anti-dilution provisions.⁴⁷ This table illustrates the main characteristics of these deals:

No.	Deal (capital increase via issuing common share)	Is there a provision against percentage dilution?	Is down round prohibited?	Remarks
A	BOCOM-HSBC (2004, Banking)	Yes	No	In case of down round chase target
B	DGME-CBF (2005, IT)	Yes	Yes	N/A
C	ABC-SSF (2010, Banking)	Yes	No	N/A
D	CUT-TCPE (2011, IT)	No	Yes	In case of down round chase founder
E	LXC-DLC (2011, Chemicals)	Yes	Yes	N/A
F	ICBC-Investors (2006, Banking)	Yes	No	N/A

A. BOCOM-HSBC Deal

The Bank of Communications Co., Ltd. (“BOCOM”) is a limited liability joint stock company incorporated in the PRC.⁴⁸ It was listed on the Hong Kong Stock Exchange in June 2005 and the Shanghai

⁴⁵ According to publicly available information, no deal governed by PRC law involves the issuance of preferred shares.

⁴⁶ Sometimes, new investors may acquire shares from the founder shareholders, through paying money to the founder shareholders instead of injecting into the target company. In this article, private placement refers to issuance of equity through capital increase rather than share transfer.

⁴⁷ See discussion *infra* Part III.

⁴⁸ *Global Offering*, BANK OF COMMUNICATIONS CO. LTD., <http://globaldocuments.morningstar.com/documentlibrary/document/2adebcad3e8d9130.msdoc/original> (last visited Mar. 25, 2013).

Stock Exchange in May 2007.⁴⁹ On August 18, 2004, the Hong Kong and Shanghai Banking Corporation Limited (“HSBC”) subscribed 7,774,942,580 common shares through capital increase, constituting 19.9% of BOCOM’s issued share capital.⁵⁰ Due to a condition in HSBC’s subscription rules, BOCOM and HSBC entered into an Investor Rights Agreement on August 18, 2004 (“IRA”), under which HSBC was granted anti-dilution rights.⁵¹ The IRA provided:⁵² (i) If BOCOM issued additional shares, rights to acquire additional shares, or securities convertible into additional shares, HSBC would have the right to purchase additional shares, rights, or securities issued by BOCOM to maintain its percentage interest in BOCOM before the issuance. (“HSBC Percentage Maintenance Provision”) (ii) If BOCOM wished to issue, in a private placement, additional shares or securities convertible into additional shares, or if BOCOM launched a public offering and the new share price fell below what HSBC paid for the 19.9% equity interest in BOCOM (“HSBC Price”), then BOCOM would first have to make cash payments and/or issue bonus shares to HSBC. The value of the cash payments and/or bonus shares would be calculated based on the difference between the HSBC Price and the new share price. (“HSBC Price Adjustment Provision”) The HSBC Percentage

⁴⁹ *Bank Profile*, BANK OF COMMUNICATIONS CO. LTD., <http://www.bankcomm.com.hk/en/aboutus/bankprofile.html> (last visited Mar. 25, 2013).

⁵⁰ *Global Offering*, *supra* note 48, at 95, 236.

⁵¹ *Id.* at 95–96.

⁵² *Id.* (“If, during the period ending on the listing of our Shares outside of the PRC through an initial public offering, we issue any additional Shares, or any rights to acquire additional Shares, or any other securities convertible into additional Shares, HSBC will, subject to all applicable PRC laws and regulations and certain limited exceptions relating to stock option plans and business combinations involving our Company, have the right to purchase such number of additional Shares or rights or securities to be issued by us so as to maintain HSBC’s percentage interest in our Company immediately prior to such issuance[...]. During the period ending on our initial public offering involving the listing of our Shares outside of the PRC, if we wish to issue any additional Shares, or other securities convertible into additional Shares, in a private placement (other than any issuances in a private placement in the PRC to entities organized or incorporated and existing in the PRC in which no foreign person owns, directly or indirectly, voting securities), or if we launch a public offering, and the price per share in such issuance or public offering is to be below the price per share paid by HSBC under the share subscription agreement for the 19.90% equity interest in our Company (the “Share Subscription Price”), we must make cash payments and/or issue bonus Shares to HSBC, the amount and/or number of which will be calculated by reference to the difference between the price paid by HSBC under the share subscription agreement and the price for the same number of new Shares under the new issuance or public offering (“HSBC Price Adjustment Top-Up”), before we may complete the new issuance or public offering. Save for any cash payments and/or bonus Shares to be made or issued to HSBC under the HSBC Price Adjustment Top-Up in connection with the Global Offering, the HSBC Price Adjustment Top-Up shall cease to apply after the listing of our H Shares. The Share Subscription Price is lower than the minimum price of the indicative Offer Price range. Based on such price range, it is expected that the HSBC Price Adjustment Top-Up right will not be exercised.”).

Maintenance Provision protects HSBC from percentage dilution by giving it the right to purchase additional shares. The HSBC Price Adjustment Provision protects HSBC from economic dilution by requiring BOCOM to pay cash or issue bonus shares to HSBC. In addition, the HSBC Price Adjustment Provision imposes compensation obligations on BOCOM instead of its founder shareholders.

B. DGME-CBF Deal

Jiangsu Dongguang Micro-Electronics Co., Ltd. (“DGME”) is a limited liability joint stock company incorporated in the PRC. It was listed on the Shenzhen Stock Exchange in November 2010.⁵³ In December 2005, China-Belgium Direct Equity Investment Fund (“CBF”) paid for 20,408,163 common shares through capital increase, paying RMB 1.96 per share. This purchase represented 29.93% of DGME’s issued share capital.⁵⁴ CBF and the seven founding shareholders of DGME also signed a capital increase agreement (“DGME Capital Increase Agreement”) granting CBF anti-dilution rights.⁵⁵

Under the DGME Capital Increase Agreement, CBF generally permits DGME to issue additional shares to third parties if: (i) Such issuance does not cause CBF’s percentage interest in DGME to fall below 25%. (“CBF Percentage Maintenance Provision”) (ii) The share price of the new issuance is not less than the RMB 1.96 per share paid by CBF. (“DGME Down Round Prohibition Provision”)⁵⁶

The CBF Percentage Maintenance Provision protects CBF against percentage dilution. The DGME Down Round Prohibition Provision protects CBF against economic dilution by prohibiting down round financing by DGME.

C. ABC-SSF Deal

The Agricultural Bank of China (“ABC”) is a limited liability joint stock company incorporated in the PRC. It was listed on the Shanghai Stock Exchange and Hong Kong Stock Exchange in July 2010.⁵⁷ On April 21, 2010, China’s National Social Security Fund

⁵³ See *Jiangsu Dongguang Weidian Gufen Youxian Gongsi Shouci Gongkai Faxing Gupiao Zhaogu Shuomingshu* (江苏东光微电子股份有限公司首次公开发行股票招股说明书) [*Prospectus for Initial Public Offering of Jiangsu Dongguang Micro-Electronic Co., Ltd.*], CSRC.GOV.CN, 1, 22, <http://www.csrc.gov.cn/pub/zjhpublic/G00306202/201009/P020100921564912966779.pdf>.

⁵⁴ *Id.* at 42.

⁵⁵ *Id.* at 43–44.

⁵⁶ See *id.* at 44.

⁵⁷ *Company Overview*, AGRICULTURE BANK OF CHINA, <http://www.abchina.com/en/about-us/about-abc/Overview/> (last visited Mar. 26, 2013).

(“SSF”), ABC, and its two existing shareholders executed a stock subscription agreement (“ABC Subscription Agreement”). Under this agreement, the SSF subscribed for 10 billion common shares through capital increase at RMB 1.55 per share. This purchase represented 3.7% of ABC’s issued share capital. The SSF was granted anti-dilution rights.⁵⁸

Under the ABC Subscription Agreement, the SSF was granted the right to purchase newly issued shares in ABC’s initial public offering (“IPO”) at the IPO price to maintain the SSF’s percentage interest in ABC immediately prior to the IPO. This provision was drafted to protect the SSF from percentage dilution in ABC’s upcoming IPO.

D. CUT-TCPE Deal

Beijing Card Union Technology Co., Ltd. (“CUT”) is a joint stock company incorporated in the PRC with limited liability, and was listed on China’s Stock Transfer Agent System (an over-the-counter securities market) in July 2012.⁵⁹ On December 25, 2011, Tianjin Chunxin Private Equity Fund (“TCPE”), CUT and its two existing individual shareholders executed an investment agreement (“CUT Investment Agreement”), under which TCPE subscribed for 999,880 common shares through capital increase at a price of RMB 15 per share. This purchase represented 16.665% of CUT’s issued share capital. TCPE was granted anti-dilution rights.⁶⁰

According to the CUT Investment Agreement:

(i) If CUT issues any additional shares through further capital increase, the pre-money valuation adopted by new investors may not be lower than the post-money valuation adopted by TCPE under the current deal. (“TCPE Down Round Prohibition Provision”)

(ii) If down round financing does occur, TCPE may adjust its percentage interest in CUT to protect against dilution and two existing individual shareholders of CUT will be obligated to pay cash to TCPE as compensation. (“TCPE Adjustment Provision”)⁶¹

⁵⁸ *Zhongguo Nongye Yinhang Fufen Youxian Gongsì Shouci Gongkai Faxing Gupiao (A Gu) Zhaogu Shuomingshu (Shenbao Gao)* (中国农业银行股份有限公司首次公开发行股票(A股)招股说明书(申报稿)) [ABC Prospectus for Initial Public Offering], CHINA SECURITIES REGULATORY COMMISSION, 53, 60, <http://www.csrc.gov.cn/pub/zjhpublic/G00306202/201006/P020100604619997811584.pdf>.

⁵⁹ *Beijing Kailian Keji Gufen Youxian Gongsì Gufen Baojia Zhuanrang Shuomingshu* (北京卡联科技股份有限公司股份报价转让说明书) [Prospectus for Stock Quotation and Transfer of Beijing Card Union Technology Co., Ltd.], HEXUN, 8, 10, http://download.hexun.com/ftp/all_stockdata_2009/all/061%5C243%5C61243240.pdf.

⁶⁰ *Id.* at 16–17.

⁶¹ *Id.* at 16.

The TCPE Down Round Prohibition Provision is designed to prohibit down round financings by CUT. Interestingly, the TCPE Adjustment Provision helps TCPE secure anti-dilution rights to protect against economic dilution if down round financing actually occurs. This kind of anti-dilution provision may put TCPE in a favorable position, if the validity and enforceability of the TCPE Down Round Prohibition Provision are reviewed under Chinese law.⁶²

E. LXC-DLC Deal

Nantong Longxiang Chemical Co., Ltd. (“LXC”) is a limited liability company incorporated in the PRC.⁶³ On July 1, 2011, Hubei Dinglong Chemical Co., Ltd. (“DLC”) obtained 44% of LXC’s issued share capital through capital increase.⁶⁴ DLC was granted the following anti-dilution rights: (i) LXC may only introduce new investors if the percentage interest held by the new investors in LXC does not exceed 10%. (“DLC Percentage Maintenance Provision”) (ii) In any new capital increase, the price per share for additional shares may not be less than the share price paid by DLC in the current capital increase. (“LXC Down Round Prohibition Provision”)⁶⁵ The DLC Percentage Maintenance Provision protects DLC against percentage dilution, while the LXC Down Round Prohibition Provision is designed to prohibit down round financing.

F. ICBC-Investors Deal

The Industrial and Commercial Bank of China Limited (“ICBC”) is a joint stock company incorporated in the PRC with limited liability.⁶⁶ It was listed on the Hong Kong Stock Exchange and Shanghai Stock Exchange in October 2006.⁶⁷ On January 27, 2006, ICBC entered a strategic investment and cooperation agreement with Goldman Sachs, Allianz Group and American Express.⁶⁸ On June

⁶² For a more detailed discussion of the TCPE Down Round Prohibition Provision, see *infra* Part III(B).

⁶³ Hubei Dinglong Huaxue Gufen Youxian Gongsi guanyu Duiwai Touzi ji Chaomu Zijin Shiyong Jihua de Gonggao (湖北鼎龙化学股份有限公司关于对外投资暨超募资金使用计划的公告) [Public Announcement on Outward Investment Plan of Hubei Dinglong Chemical Co., Ltd.], HEXUN, 2, http://download.hexun.com/ftp/all_stockdata_2009/all/061%5C907%5C61907124.pdf.

⁶⁴ *Id.* at 4.

⁶⁵ *Id.* at 6.

⁶⁶ ICBC Prospectus for Initial Public Offering, HKEX NEWS, <http://www.hkexnews.hk/listedco/listconews/SEHK/2006/1016/LTN20061016000.htm> (last visited March 27, 2013).

⁶⁷ ICBC Announces 2006 Performance, ICBC (Apr. 9, 2007), <http://www.icbc.com.cn/ICBC/ICBC%20NEWS/icbc%20announces%202006%20performance.htm>.

⁶⁸ ICBC Memorabilia, ICBC, <http://www.icbcltd.com/ICBCLtd/About%20Us/ICBC%20History/> (last visited March 27, 2013).

29, 2006, SSF completed its investment in ICBC.⁶⁹ SSF is responsible for managing and operating China's national social security fund, and held around 5% of ABC's outstanding shares upon the said investment deal. Goldman Sachs, Allianz Group, American Express and SSF are hereafter referred to as the "Investors."

To allow the Investors to maintain their percentage stakes, ICBC granted each of them the right to purchase ICBC's common shares in its upcoming IPO.⁷⁰ This arrangement protected the Investors from suffering percentage ownership dilution in ICBC's upcoming IPO. In the banking industry, pre-IPO deals like the ABC-SSF Deal and the ICBC-Investors Deal only contain provisions protecting against percentage dilution, whereas provisions protecting against economic dilution are not found.⁷¹

IV. VALIDITY AND ENFORCEABILITY OF ANTI-DILUTION PROVISIONS UNDER PRC LAW

Western-style anti-dilution provisions are crafted based on the issuance regime of preferred stock. However, according to Professor Shen Wei, "[t]he concepts of share, authorized capital, and issued capital are not used in the limited liability companies under Chinese corporate law ... the issuance of preferred shares is made impractical."⁷² Chinese lawyers cannot simply adopt a Western template when drafting anti-dilution provisions in Chinese private placement deals. To deal with the lack of a preferred stock issuance regime, certain Chinese-style anti-dilution provisions have been created. These include percentage maintenance provisions,⁷³ down round prohibition provisions, and down round adjustment provisions.⁷⁴ The next section analyzes the validity and enforceability of Chinese-style anti-dilution provisions under the

⁶⁹ See *ICBC Prospectus for Initial Public Offering*, *supra* note 66, at 9.

⁷⁰ *Id.* at 90 ("We have granted each of our overseas strategic investors and the SSF a right to purchase our H shares in the Global Offering at the offer price to maintain its percentage of ownership interest in our shares.").

⁷¹ It may be reasonably concluded that investors are more confident in avoiding any down round financing when they put their money into the banking industry, especially when the target banks are China's state-owned banks. The BOCOM-HSBC Deal is an exception, as HSBC obtains provisions protecting against potential economic dilution.

⁷² Shen, *supra* note 4, at 99–100.

⁷³ Commonly, a "pure" decline in percentage interest is not dealt with in anti-dilution provisions. However, such percentage maintenance provisions are discussed in this part, because the anti-percentage-dilution provisions are widely adopted in Chinese private placement deals, see *supra* Part II.

⁷⁴ See discussion *supra* Part III(C).

PRC Company Law and an array of Chinese foreign investment regulations (the “PRC FIR”).⁷⁵

If the target company or investor contains no foreign element, the PRC Company Law will govern the deal, but the PRC FIR will not apply. Under the PRC Company Law, companies are divided into limited liability companies and joint stock companies. If the target company is a foreign-invested company (“FIE”) or the investor is a foreign entity, deals will be governed by the PRC Company Law and the PRC FIR. The PRC FIR group FIEs into three types: equity joint ventures (“EJVs”), cooperative joint venture (“CJVs”), and wholly foreign-owned enterprise (“WFOEs”). The PRC Company Law and PRC FIR both apply to FIE. The PRC FIR prevail if they conflict with the PRC Company Law.⁷⁶ Under the FIR, FIEs mainly take the form of limited liability companies, as specified in the PRC Company Law. The following table illustrates the forms taken by FIEs under the PRC FIR:

	EJV	CJV	WFOE
FIE Forms Under PRC FIR	<ul style="list-style-type: none"> Limited liability company 	<ul style="list-style-type: none"> Limited liability company if obtaining legal personality Other forms if not obtaining legal personality 	<ul style="list-style-type: none"> Limited liability company Other forms of liability, subject to special approval

A. Percentage Maintenance Provisions

Based on the discussion in Part II, the percentage maintenance provisions grant the investor a right to subscribe to additional shares in the event of future capital increases⁷⁷ to maintain the investor’s percentage interest in the target company.

Article 35 of the PRC Company Law grants existing shareholders the right to subscribe to additional shares in proportion to their

⁷⁵ These regulations include (i) the Sino-Foreign Equity Joint Venture Regulations; (ii) the Sino-Foreign Cooperative Joint Venture Regulations; and (iii) the Wholly Foreign-Owned Enterprises Regulations.

⁷⁶ See *Gongsi Fa* (公司法) [Company Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 27, 2005, effective Jan. 1, 2006) art. 218 (Chinalawinfo) (“This Law shall be applicable to foreign-invested companies with limited liability and such companies limited by shares; and where laws on foreign investments provide otherwise, the provisions there shall be applicable.”).

⁷⁷ Under the percentage maintenance provisions, investors and founder shareholders do not care about whether the capital increase in the future is dilutive or not.

contributed capital when a capital increase is launched.⁷⁸ However, the PRC Company Law also allows shareholders of a limited liability company to make other arrangements.⁷⁹ The same limitation found in Article 35 is not imposed on joint stock companies. With unanimous approval, the shareholders can agree to grant specific shareholders preferential rights to subscribe to any amount of additional shares, without being subject to any limitation. This provision of the PRC Company Law lays the foundation for the validity of percentage maintenance provisions.

Under the PRC FIR, no provision currently deals with the right to subscribe to additional shares in the event of a capital increase. According to Professor Shen Wei, “[t]he Company Law will prevail only in matters related to general characteristics of a limited liability company provided that the PRC FIR are silent on such matters.”⁸⁰ The following table illustrates the applicability of pre-emptive rights in the event of a capital increase.⁸¹

	Pre-Emptive Right in Capital Increase	Right of First Refusal in Share Transfer
PRC Company Law	<ul style="list-style-type: none"> • Not mandatory for limited liability company • N/A for joint stock company 	<ul style="list-style-type: none"> • Not mandatory for limited liability company • N/A for joint stock company
PRC FIR	<ul style="list-style-type: none"> • N/A for FIE 	<ul style="list-style-type: none"> • Mandatory for EJV • N/A for CJV,⁸² WFOE

As no provision in the PRC FIR relates to pre-emptive rights in connection with a capital increase, the same should be said of the PRC Company Law. Therefore, percentage maintenance provisions are valid under both the PRC Company Law and the PRC FIR.

⁷⁸ See *Gongsi Fa* (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) art. 35 (Chinalawinfo) (“... when a company increases its capital, its shareholders shall have the pre-emptive right to make their subscriptions in proportion to the capital contributions they made, except where all the shareholders have agreed to draw the dividends not in proportion to their capital contributions or to do without the pre-emptive right in proportion to their capital contributions when making subscriptions.”).

⁷⁹ *Id.*

⁸⁰ Shen, *supra* note 4, at 97.

⁸¹ The applicability of the right of first refusal in the event of a share transfer has also been stated as a comparison.

⁸² Although the right of first refusal in a share transfer scenario is not explicitly granted to existing shareholders of a CJV under the PRC FIR, the transfer of shares in a CJV is subject to the approval of other shareholders.

B. Down Round Prohibition Provisions

Down round prohibition provisions grant investors the right to prohibit the issuance of additional shares at a price lower than what they paid. This protects investors against economic dilution caused by dilutive capital increase in the future.

Under the PRC Company Law, if a company wants to make certain fundamental decisions, the proposal must first be approved by shareholders representing two-thirds or more of the company's voting rights.⁸³ Fundamental decisions can include amending articles of association; increasing or decreasing registered capital; and engaging in mergers, split-ups, dissolution, or changes of company form. Theoretically, the PRC Company Law leaves plenty of room for down round prohibition provisions.

The approval quorum requirements for capital increase under the PRC FIR are more stringent than those of the PRC Company Law. The following table illustrates the approval quorum requirements for capital increase for the three types of FIEs:

	EJV	CJV	WFOE
Approval Quorum Requirements for Capital Increase	Unanimous approval by attending directors	Unanimous approval by attending directors or attending joint management committee members	N/A ⁸⁴

Under both the PRC Company Law and the PRC FIR, investors and founder shareholders are not prohibited from making contractual arrangements to meet the approval quorum requirement. Therefore, they can freely adopt down round prohibition provisions.

C. Down Round Adjustment Provisions

Investors are adopting down round adjustment provisions to offset damages arising from potential down round financings. In Part II, this article discussed how down round adjustment provisions are grouped into those granting recourse against target companies

⁸³ See *Gongsi Fa* (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) art. 44 (Chinalawinfo) ("[R]esolutions made at a meeting of the shareholders assembly on amendment to the company's articles of association, the increase or reduction of the registered capital, or on the merger, division, dissolution or transformation of the company shall be subject to adoption by the shareholders representing two-thirds or more of the voting rights.").

⁸⁴ As the Company Law prevails when the PRC FIR is silent on such matters, the minimum threshold of "approval by shareholders representing at least two-thirds of the voting rights" shall be applicable to WFOEs.

(“Target Company Approach”) and those granting recourse against founder shareholders (“Founder Shareholder Approach”). This article will now examine the validity of these two approaches.

Under the Target Company Approach, the target company must grant bonus shares or cash to investors if down round financings occur. As the PRC Company Law only permits a company to purchase its own shares in limited circumstances,⁸⁵ it is not practical for the target company to grant bonus shares to investors if dilutive down round financings occur. It is also not feasible for the target company to pay cash to investors, since cash payments may be a violation of the capital maintenance rules of the PRC Company Law. In principle, shareholders are prohibited from “withdrawing” their paid-in capital.⁸⁶ The capital maintenance rules are also present in other administrative rules.⁸⁷ Generally, a shareholder can only withdraw money from a company if dissolution, profit distribution or capital decrease occurs. Obtaining cash from a target company under the Target Company Approach may be considered a disguised withdrawal of paid-in capital.

Under the Founder Shareholder Approach, the founder shareholder must grant shares or cash to investors if down round

⁸⁵ See *Gongsi Fa* (公司法) [Company Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 27, 2005, effective Jan. 1, 2006) art. 143 (Chinalawinfo) (“A company shall not purchase its own shares, except where: (1) It reduces its registered capital; (2) It merges with another company that holds its shares; (3) It rewards the staff and workers of the company with its shares; or (4) A shareholder requests the company to purchase his shares because he holds objections to the resolution on the merger or division of the company adopted by the shareholders general assembly . . . Where a company purchases its own shares on grounds of Subparagraph (1) as specified in the preceding paragraph, such shares shall be cancelled within 10 days from the date it purchases them; and where the shares are purchased on grounds of Subparagraph (2) or (4), such shares shall be transferred or cancelled within six months. The number of its own shares purchased by a company in accordance with the provisions of Subparagraph (3) of the first paragraph shall not exceed five percent of the total number of the shares issued by the company; the funds used for such purchase shall be allotted from the after-tax profits of the company; and the shares purchased shall be transferred to its staff and workers within one year . . .”).

⁸⁶ *Id.* art. 36 (“Once a company is incorporated, its shareholders shall not secretly withdraw their capital contributions.”).

⁸⁷ See, e.g., *Guojia Gongshang Xingzheng Guanli Zongju guanyu Gudong Jiekuan Shifou Shuyu Choutao Chuzi Xingwei Wenti de Dafu* (国家工商行政管理总局关于股东借款是否属于抽逃出资行为问题的答复) [Reply of the State Administration for Industry and Commerce on Issues concerning Whether or Not Shareholder Borrowing Should be Deemed as Withdrawal of Capital Contributions], (promulgated by St. Admin. for Industry and Commerce, Jul. 25, 2002, effective Jul. 25, 2002) (Chinalawinfo) (“Pursuant to relevant provisions of the Company Law, companies are entitled to entire property right of the legal person formed by investments of shareholders. After shareholders input relevant property into companies by means of capital contributions, the ownership of said property transfers, and said property becomes the property of companies.”) Notably, as no explicit rule regarding the prohibition from “withdrawing” paid-in capital is contained in the PRC FIR, relevant rules in the PRC Company Law shall be applicable.

financings occur. With respect to the shares transferred from founder shareholders to investors, the PRC Company Law leaves plenty of room for contractual arrangements.⁸⁸ Although a transfer of equity in an EJV must be approved by other shareholders, the PRC FIR is silent on whether a right of first refusal must be performed in proportion to shareholding percentages.⁸⁹ This implies that the PRC Company Law governs the transfer of shares from founder shareholders to investors. In other words, such a transfer of shares is not subject to the requirement that the right of first refusal must be exercised in proportion to shareholding percentages. With respect to monetary compensation (cash payable from the founder shareholders to the investors under the Founder Shareholder Approach), the PRC Company Law and the PRC FIR do not mention any restrictive requirements on such payment arrangements, as it is a contractual arrangement between shareholders.⁹⁰ Therefore, the Founder Shareholder Approach is possible as long as no contract principles are violated.

V. CONCLUSION

As Chinese corporate law is not user-friendly for private placements,⁹¹ foreign investors and Chinese founder shareholders cannot directly transplant Western-style anti-dilution provisions in the context of Chinese private placement transactions. To gain anti-dilution protection, lawyers have “crossed the river by feeling the stones” and crafted Chinese-style anti-dilution provisions. The enforceability of Down Round Adjustment Provisions may be problematic when taking the Target Company Approach.

In addition, payments of cash or bonus shares from the target company to investors may be deemed an illegal withdrawal of paid-in capital. To avoid such a risk, the Down Round Adjustment Provisions should be drafted as a matter between the founder shareholders and the investors instead of obligating the target company to pay cash or other benefits to the investors.

⁸⁸ See *supra* graph in Part III(A).

⁸⁹ *Id.*

⁹⁰ Notably, certain basic contract principles shall be obeyed when making such a contractual arrangement, for instance, the principle of equity and principle of good faith. See *Hetong Fa* (合同法) [Contract Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999) arts. 5–6 (Chinalawinfo) (“The parties shall observe the principle of equity in defining each other's rights and obligations. The parties shall observe the principle of good faith in exercising their rights and fulfilling their obligations.”).

⁹¹ Shen Wei, *Uncertainties in Implementing a Multiple-Class Share Structure under the PRC Corporate Law and Possible Mitigation Strategies*, 31 THE COMPANY LAWYER 9 (2010), available at SSRN: <http://ssrn.com/abstract=1826344>.

On September 17, 2012, the State Council of the PRC approved and released the Twelfth Five-Year Plan for Financial Industry Development and Reform (“12th Financial Plan”), jointly compiled by China’s five major regulators of financial industries.⁹² In the 12th Financial Plan, the regulators vowed to “explore to establish preferred stock system”.⁹³ Although the 12th Financial Plan is very broad and does not delve into details, Chinese regulators’ ambition to upgrade China’s corporate law regime may provide parties in Chinese private placement transactions with hope for future reforms.

This article summarizes the popular anti-dilution provisions used in China and analyses their validity and enforceability. The founder shareholders and investors as well as their respective lawyers can rely on this analysis to better understand Chinese anti-dilution provisions and their enforceability consequences in private placement transactions.

⁹² Those five financial regulators are the People’s Bank of China, China Banking Regulatory Commission, China Securities Regulatory Commission, China Insurance Regulatory Commission and State Administration of Foreign Exchange, see *Jinrongye Fazhan he Gaige “Shierwu” Guihua Fabu* (《金融业发展和改革 “十二五” 规划》发布) [“Twelfth Five-Year” Plan for Financial Industry Development and Reform Promulgated], PEOPLE’S BANK OF CHINA, http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2012/20120917155836347504341/20120917155836347504341_.html (last visited May 15, 2013).

⁹³ *Id.*

