TAKING SECURITY IN PRIVATE EQUITY INVESTMENTS IN CHINA

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A note covering the Chinese law and practice of taking a security interest in the context of a private equity investment in a company incorporated in China. The note covers the types of security interest that exist in the Chinese system, includes diagrams and explanations of the principal security structures used in practice and provides practical guidance on the documents involved, negotiation and drafting points and procedural issues. The note has been drafted from the perspective of the adviser to the private equity investors. This document is published by Practical Law and can be found at: global.practicallaw.com/8-631-7089

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TAKING SECURITY IN PRIVATE EQUITY INVESTMENTS IN CHINA

SCOPE OF THIS NOTE

This note explains the legal and practical issues involved in taking security over assets in China, including the equity interest of a Chinese company, in the context of a private equity (PE) investment in a company registered in China. It looks at:

- The legal framework creating security interests under Chinese law.
- The principal scenarios involving security interests encountered in PE transactions, which are:
  - the grant of a security interest to a commercial bank to secure a loan that will be used to acquire an interest in a Chinese company;
  - the grant of a security interest to a PE investor to secure its rights under convertible or exchangeable debt instruments issued by the acquisition target or its controlling shareholder; and
  - the treatment of security interests in the context of the PE investor's exercise of a redemption or indemnification right under the investment documents.
- The limits to the effectiveness of security interests in these scenarios.
- The security documents involved in a PE transaction and their impact on a transaction timetable.
- Special considerations that affect security rights, such as the involvement of a **foreign-invested enterprise** (FIE), publicly listed company or **state-owned enterprise** (SOE).

This note does not consider in detail China's laws governing the grant of security interests generally. For a detailed discussion of the different types of security interest that exist in China and the legal framework within which they exist, see *Practice note, overview, Taking security in China*.

The note adopts the perspective of an adviser to a PE investor. It is assumed that the investor's interest will be ensured as far as possible that:

- Any security it has to grant covers no more than the minimum assets necessary to obtain financing for its acquisition.
- The security that it obtains is sufficient for it to obtain the projected internal rate of return (IRR) if it becomes necessary to enforce its contractual rights under the investment agreements, and will be capable of being enforced in this scenario.

LEGAL FRAMEWORK

The principal laws governing security interests in China are:

- The *Property Law of the People's Republic of China 2007* (2007 Property Law).
- The *Security Law of the People's Republic of China 1995* (1995 Security Law).
- The judicial interpretations of these two laws released by the **Supreme People's Court** (SPC) from time to time.

These laws create four types of security that are available to creditors generally:

- Guarantees.
- Mortgages.
- Pledges.
- Deposits.

The framework also allows for the creation of liens (that is, security interests that arise as a result of particular circumstances), but as these arise by operation of law they cannot be used to secure a contractual obligation.

GUARANTEE

A guarantee is the agreement of a guarantor to agree to repay the debts or assume the liabilities of the principal obligor to a creditor if the principal fails to repay its debts or fulfil its liabilities when they become due (*Article 6, 1995 Security Law*). A guarantee is characterised as a form of security under the 1995 Security Law, but unlike other security interests, it is not a property interest created over the assets of the person who grants the security (that is, the **guarantor**).

Two types of guarantee exist under Chinese law:

- Ordinary guarantee.
- Joint liability guarantee.

Under an ordinary guarantee, the guarantor's liability is only enforceable after:

- The guaranteed party (that is, the creditor) has obtained a judgment or arbitral award in its favour against the principal obligor under the principal contract.
- The principal obligor's liability under that judgment or arbitral award cannot be fulfilled after any assets available to the principal have been legitimately seized.

(*Article 17, 1995 Security Law*.)

A joint liability guarantee allows the guaranteed party to enforce the guarantee against the guarantor directly as soon as the payment deadline under the principal contract has passed (*Article 18, 1995 Security Law*).

Unless the parties expressly state otherwise, a guarantee governed by Chinese law will be a joint liability guarantee (*Article 19, 1995 Security Law*).

For a detailed review of the treatment of guarantees under Chinese law, see *Practice note: Guarantees (China): overview.*

MORTGAGE

A mortgage is a form of security over assets, where one party (the **mortgagor**), without transferring the ownership or possession of the assets, creates security over the assets owned by the mortgagor to secure the obligations (the **secured obligations**) of the underlying obligor. If the underlying obligor fails to perform the secured obligations or any of the agreed enforcement events occurs, the beneficiary (the **mortgagee**) has the right to enforce the

mortgage and collect the enforcement proceeds as a priority (*Article 197, 2007 Property Law* and *Article 33, 1995 Security Law*).

Most assets can be mortgaged, except those that cannot be freely transferred or have significant ownership defects. For a complete list of the types of asset that can be used for a mortgage, see *Practice note, Taking security in China: Types of asset that can be used for a mortgage*.

Chinese law permits the creation of floating mortgages. A floating mortgage is a special form of mortgage that is created over unspecified operational assets of the mortgagor such as equipment, products and inventory, until crystallization, usually on the enforcement of the mortgage.

A mortgage over real estate will only take effect once the mortgage is registered with the local real property administration agency. For most other assets such as equipment, raw materials, products, vessels and aircrafts, a mortgage will take effect as soon as a mortgage agreement has been entered into between the mortgagor and the mortgagee. Mortgage registration over such assets is not mandatory for a mortgage to become effective, but it will secure the validity of the mortgagee against a bona fide third party. Therefore, from the perspective of a mortgagee, it should generally insist that a mortgage over non-real estate assets is also registered with the appropriate body. For a list setting out the registration authority for each type of asset, see *Practice note, Taking Security in China: Registration authority for mortgages of each type of asset*.

PLEDGE

A pledge is a form of security in which one party (the **pledger**) creates security over its movables or rights to secure the obligations of the underlying obligor, and if the underlying obligor fails to perform the secured obligations or any of the agreed enforcement events are triggered, the beneficiary (the **pledgee**) will have the right to enforce the security and collect the enforcement proceeds as a priority (*Articles 208, 223 and 224, 2007 Property Law* and *Articles 63, 75, 76, 78 and 79, 1995 Security Law*).

Pledges may be given over tangible movable property or intangible rights such as accounts receivable. For more information on pledges, see *Practice note, Taking security in China: Pledge*.

DEPOSIT

A deposit (定金) is the money given by one party to the other party as a security for either:

- A covenant to enter into a contract.
- An obligation to perform the contract.

For more information on deposits, see *Practice note, Taking security in China: Deposit*.

TAKING SECURITY IN PRIVATE EQUITY INVESTMENTS IN CHINA

Although it has developed rapidly in the past ten years, China's domestic PE industry is still young. One important factor is the lack of use of debt instruments in the practice of PE transactions in China: they are much less commonly seen here than in other more developed economies. This is partly because legislators and regulators have historically viewed debt instruments largely through the lens of the potential risks that they could pose to the stable development and reform of the country's banking and financial system. Consequently, debt instruments or equity financing with debt characteristics were (and still are) generally not well recognized by the country's system of corporate law.

For example, merger and acquisition (M&A) loans were prohibited in most cases and, where permitted, were subject to severe restrictions until the release of the *Guidelines for the Risk Management of M&A Loans Granted by Commercial Banks 2015* (商业银行并购贷款风险管理指引) (2015 M&A Loan Guidelines) by the **China Banking Regulatory Commission** (CBRC).

Similarly, loans between nonfinancial companies or other entities were not formally permitted until September 2015 (*Article 11, Provisions of the Supreme People's Court on Certain Issues concerning Application of Law in Trial of Cases involving Private Lending 2015*), and remain available only on a limited basis. For more information on this development, see *Legal update, SPC upholds non-bank private lending*.

In addition, convertible securities (that is, debt that can be converted into equity (or vice versa) in the underlying target) are not expressly recognized under Chinese law (subject to some limited exceptions for publicly traded companies).

In response, market practice has evolved more complicated alternative structures to achieve a similar economic effect for investors as that would have been achieved by a debt involved equity investment structure.

TYPICAL SECURITY SCENARIOS

In a private equity context, issues of taking security typically arise in three contexts:

- The grant of a security interest to a commercial bank to secure a loan that will be used to acquire an interest in a Chinese company (see *Security supporting acquisition loans*).
- The grant of a security interest to a PE investor to secure its rights under convertible debt instruments issued by the acquisition target and/or its affiliate (see *Security supporting convertible securities structures*).
- The treatment of security interests in the context of the PE investor's exercise of a valuation adjustment right (see *Security supporting valuation adjustment mechanisms*).

SECURITY SUPPORTING ACQUISITION LOANS

An acquisition loan means a loan granted by a commercial bank to the acquirer (or its subsidiary) to finance a proposed merger or acquisition (a leveraged acquisition). If the acquisition will result in the acquirer obtaining formal or effective control of the target, this structure is referred to as a **leveraged buyout** (LBO). For more information on buyouts, which evolved in the context of the US private equity industry, see *Practice note, Buyouts: Overview*.

Historically, the Chinese authorities have considered leveraged acquisition to be a high risk financial activity. For this reason, rules were introduced in 1995 under which acquisition loans were prohibited in most cases and, where allowed, were subject to severe restrictions (*Article 20,* General Rules of Loans 1996).

Starting in 2005, the Chinese government began to allow acquisition loans on a case-by-case basis (that is, each individual loan generally required approval from the CBRC). Almost all of these approvals were granted for loans to SOEs.

In December 2008, the CBRC released the M&A Loan Guidelines, which allowed qualified commercial banks to provide loans to facilitate various types of onshore merger and acquisition activity. The guidelines were subsequently

amended in February 2015.

Despite these liberalisations, in the current practice, commercial banks remain subject to strict limitations on the circumstances in which they can extend acquisition loans. Though there have been some examples of leverage used in acquisitions involving large-scale industrial investors (such as a public company or SOE), it has not yet played a significant role in China's domestic PE industry.

ACQUISITION LOAN SECURITY STRUCTURE

In a typical LBO, the PE investor (sometimes with the management team of the target company and/or other investors) will establish a holding company (HoldCo), through which it will acquire the target company (usually the operating company, including its subsidiaries, if any) with a significant amount of financing provided by a bank (or a syndicate). In this structure, the bank is the creditor and the secured party, and the HoldCo is usually the borrower. The bank will require either or both of HoldCo and the target to provide various forms of security for Holdco's obligations under the facility agreement for the acquisition loan.

A simplified structure is illustrated below:

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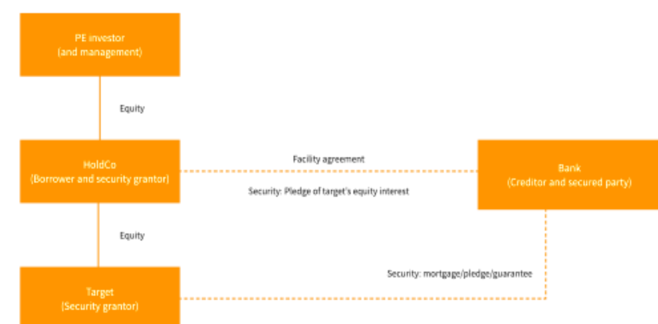
Taking security in private equity investments in China (chart 1)



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Typically, unlike regular commercial loans, when making an acquisition loan the lender is not assessing its risk on the basis of the creditworthiness of the borrower or the investor but that of the target (or target group if it has subsidiaries). This is not the same case in the Chinese market though, where banks will most possibly also probe into the financial situations of the borrower and its parent company, which is one of the reasons that they tend to extend acquisition loans to large-scale public companies or SOEs in the current practice.

The lender will press for a security interest over at least the equity interest of the target (that is, the assets of HoldCo). If available, the lender will want to avoid issues of structural subordination by also taking security over any major assets of the target or its subsidiaries, such as real property, fixed assets and important intellectual property.

SECURITY INTERESTS

An acquisition loan typically involves the following security interests, which secure the obligations of the HoldCo under the acquisition loan facility agreement:

- Pledge of HoldCo's equity interest in the target. If the target has subsidiaries, this should be accompanied by separate pledges of each successive company's interest in the equity of its subsidiaries.
- Mortgage or pledge of the principal assets held by the target (and its subsidiaries, if applicable).
- Guarantee by the target (and its subsidiaries, if applicable).

COMMON VARIANTS

Common variants to the typical acquisition loan security structure include:

- **Transfer of acquisition loan to target.** Depending on the tax status of the parties, there may be tax advantages to having HoldCo transfer the acquisition loan to the target in a debt restructuring.
- **Merger of HoldCo and target.** If there is a chance that minority shareholders will not approve the LBO (for example, if the target is a publicly-owned company with activist shareholders who may hold out for a higher price), it may be possible to circumvent their approval by merging the HoldCo into the target.

SECURITY SUPPORTING CONVERTIBLE SECURITIES STRUCTURES

If a target company has a low credit rating and high growth potentials, the investor may wish to structure its investment in the target as convertible or exchangeable debt (together, "convertible securities") instead of taking equity directly. Convertible debt (CB) is a form of security issued by a company that gives its holder the option to convert the debt into another type of newly issued securities of the issuer. Exchangeable debt (EB) gives the holder the option to exchange the debt for existing securities of a third party (that are normally owned by the issuer of the exchangeable debt). The security into which a debt security may be converted or exchanged is usually an equity security, for example shares or equity interest in a company. Conversion or exchange is typically at the investor's discretion.

The use of convertible securities in a PE context emerged out of practice in the United States and the United Kingdom, and there are differences in the approach taken under UK and US-style documents and deal structures. For a detailed discussion of convertible securities under each system, including an examination of the common features and structure of a convertible security offering, tax implications and the advantages and disadvantages of an offering for the issuer and the investor, see:

- *Practical Law UK Finance, Practice note, Convertible and exchangeable bonds*.
- *Practical Law US Finance, Practice note, Convertible Bonds: Overview*.

CONVERTIBLE SECURITIES IN CHINESE TARGETS

Chinese company law does not expressly allow for the issuance of convertible securities except for CB by a public company (that is, a company whose shares are publicly traded on the Shanghai or Shenzhen stock exchanges, or the National Equities Exchange and Quotations (NEEQ), the country's over-the-counter market). There is no current legal framework to permit the issuance of convertible securities by other kinds of companies (either a limited liability company or joint stock company).

For investments in non-public Chinese companies, it is possible to achieve a similar result to a CB or EB using a contractual alternative. In a contractual structure, the target or its controlling shareholder:

- Issues debt to the investor.
- Separately and simultaneously grants the investor an option to acquire a predetermined amount of equity in the target (that is, a call option).

Contractual convertible securities structure is often an element in **variable interest entity** (VIE) structures (that is, structures where the investor or holding company does not

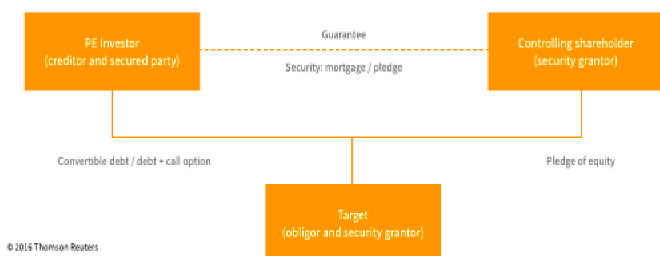
acquire equity in the target operating company directly but seeks to control it through contracts). For a full discussion of VIE structures, see *Practice note, Variable interest entity (VIE) structures in China*.

As with VIE structures themselves, the use of a contractual workaround to achieve a commercial goal that is not expressly permitted under Chinese law (that is, the issuance of convertible debt by an unlisted company) carries the risk that it may not be legally or practically enforceable. The risk that the call option may not be enforceable against the target should be brought to the client's attention when advising on setting up a contractual convertible securities structure.

CONVERTIBLE SECURITY STRUCTURE

In a typical convertible debt structure, the target company is the debt issuer or obligor, the PE investor is the creditor and the secured party, and the target company, principal shareholders and their affiliates will usually provide various forms of security to secure the underlying debt if the investor chooses not to convert it to equity investment. In an exchangeable debt structure, the controlling shareholder will replace the target as the direct obligor, but is otherwise similar to a CB structure.

A simplified CB structure is illustrated below:



A convertible securities structure typically involves taking security at three levels:

- Pledge of the equity interest in the target held by the controlling shareholder (and if applicable, the equity in the target's subsidiaries, and/or other affiliates of the controlling shareholder).
- Mortgage or pledge over the major assets held by the target. This can be extended to assets of the target's subsidiaries (if any) and to the unrelated assets (if feasible) of the controlling shareholder and its affiliates if the investor's negotiating position is strong enough.
- Guarantee by the controlling shareholder (and its affiliates, if applicable) of the target's obligations (in an EB structure, this guarantee might be granted by the target as the controlling shareholder would be the direct obligor).

SECURITY SUPPORTING VALUATION ADJUSTMENT MECHANISMS

As PE investments are inherently risky, PE investors seek a high return on their invested capital to compensate for the high level of risk. The models used by PE investors assume that their investments will reach a certain IRR (for a detailed discussion of the concept, use and calculation of internal rate of return, see *Practice note, Internal rate of return (IRR): an introduction*).

Investors protect their IRR by negotiating rights and protections into their investment documents. These rights are triggered by the occurrence of an event or events that threaten the IRR, for example:

Failure to meet financial targets (such as net income targets or a specified compound annual growth rate).

Failure to achieve an exit (for example by way of an IPO) within a certain time frame.

Taking any action to frustrate or prevent an exit (for example, voting against the decision to conduct an IPO).

Material breach of the investment agreements.

Two types of protection are more commonly seen in China-based PE investments:

Put options (that is, the right to sell the investment back to the target or founder at a price that would achieve the desired IRR). Typically these are structured as a redemption of the investment debt or equity by the target, backed up by an obligation by the target's controlling shareholder to make good any shortfall.

Indemnifications of the investor by the target and its controlling shareholder, for liquidated amount that would achieve the desired IRR.

The IRR protections can be made good in cash, by issuing additional equity in the target or by transferring equity interest held by the controlling shareholder in the target, at the option of the investor.

As the effect of these provisions is to adjust the implied valuation of the target, they are often referred to as valuation adjustment mechanisms (VAM), and the clauses that give effect to them as VAM clauses.

VAM CLAUSES IN CHINESE PRACTICE

Although VAM obligations are a normal part of PE investment, they have a checkered reputation in China, where they are popularly referred to as "对赌协议" (bet-on agreements). There is a risk that the obligations of a target company under a VAM clause are subject to challenge under Chinese law and may be held to be invalid, on the grounds that VAM protection unfairly privileges the interests of the PE investor over the interests of other shareholders and creditors of the target company, by allowing the investor to obtain a fixed profit unconnected with the performance of the invested company. This was the view taken by the SPC in Haifu Investment v. Gansu Shi Heng Non-Ferrous Recycling Co., Ltd and Hong Kong Diya Limited (Supreme Court, (2012) Min Ti Zi No. 11). However, VAM obligations assumed by a target's controlling shareholder are normally recognized and respected. When drafting a VAM clause, you should make sure that the obligations apply to the controlling shareholder(s), and any affiliates.

VAM SUPPORT SECURITY STRUCTURE

In a typical VAM support structure, the VAM obligations of the target (if any) and the controlling shareholder are supported by both the controlling shareholder and the target. A simplified structure is illustrated below:

Security is usually given at three levels:

- Pledge of the controlling shareholder's equity interest in the target. If the target has subsidiaries, this should be accompanied by separate pledges of each successive company's interest in the equity of its subsidiaries.
- Mortgage or pledge of the target's most valuable assets. This can be extended to assets of the target's subsidiaries (if any) and to the unrelated assets (if feasible) of the controlling shareholder and its affiliates if the investor's negotiating position is strong enough.
- Guarantee by the affiliates of controlling shareholder, the target, and its subsidiaries (if any).

COMMON FORMS OF SECURITY: EQUITY PLEDGE

The most common form of security in China's PE transactions is a pledge of equity in a Chinese company. Equity in this context means:

- The equity interest in a limited liability company.
- Shares in a joint stock limited company (or corporation limited).

In addition to the equity held by the targets controlling shareholder in the target, the equity of any subsidiaries or intermediate holding companies of the target is usually pledged as well.

REQUIREMENTS FOR A VALID AND ENFORCEABLE EQUITY PLEDGE

For a pledge of equity in a Chinese company to be valid and fully enforceable:

- The subject equity interest must be freely transferable (*Article 75, 1995 Security Law*).
- The pledge must be registered with the appropriate body (*Article 226, 2007 Property Law*).

When advising a client that is taking a pledge over the equity of a Chinese company, you should use the due diligence period to find out whether these conditions can be met.

RESTRICTIONS ON THE FREE TRANSFER OF EQUITY INTEREST

There are a number of ways in which the equity interest in a Chinese company can be subject to transfer restrictions. In particular, you should always check:

- Has the equity already been pledged to a third party? Though theoretically possible, most local equity pledge registration agencies will refuse to register a secondary pledge of an equity interest that has already been pledged (for details on equity pledge registration, see *Registering an equity pledge* below).
- Has the target or the controlling shareholder entered into any contract with a third party that contains a clause prohibiting or restricting transfers in the equity? For example, would enforcement of the pledge trigger a change of control provision by which the target is bound?
- Does any other shareholder in the target have a statutory or contractual right of first refusal over the shares? For example, the shareholders in a **Sino-foreign equity joint venture company** (EJV) have a statutory right of first refusal to buy the shares of a departing shareholder.
- Is the company a joint stock company that was incorporated less than a year ago? If so its shares cannot be transferred (*Article 141, Company Law of the People's Republic of China 2013* (2013 Company Law)).
- Is the company listed on the Shanghai or Shenzhen stock exchange? If so, a number of prohibitions on transfer may apply. For a list of these prohibitions, see *Pledges over equity in a listed company*.

Unless the transfer of subject equity is expressly prohibited, restrictions on the transfer of equity interest do not necessarily mean that the pledge is worthless. Conditional prohibitions or restrictions can be cured. Depending on the type of restriction, this may mean:

- Delaying enforcement until after any restricted period has ended (for example, a share lockup).
- Obtaining the approval by, or notifying, any third party that has a right in relation to the transfer of the equity.

REGISTERING AN EQUITY PLEDGE

A pledge over equity in a Chinese company can only be enforced if it has been registered with the appropriate body. This will depend on whether the equity has been registered with a securities depository and clearing institution or not:

- If the securities are registered with the China Securities Depository & Clearing Corporation Limited (CSDC) (that is, if such securities are publicly traded on the Shanghai or Shenzhen stock exchanges, or NEEQ), the pledge should be registered with that institution.
- If the securities have not been registered with a clearing institution, the pledge should be registered with the **State Administration for Industry and Commerce** (SAIC) or its competent local branch (AIC office) with which the subject company is incorporated or registered.

(*Article 226, 2007 Property Law* and *Article 3,* Measures for the Registration of Share Pledge with Industry and Commerce Administration Authorities 2016 (2016 Share Pledge Measures).)

DOCUMENTS AND TIMELINE TO REGISTER AN EQUITY PLEDGE

To register an equity pledge, the registrant normally needs to submit the following documents to the relevant registrar:

- Application letter for registering an equity pledge.
- Pledge contract.
- Shareholder ledger or other document evidencing the pledger's equity interest in the subject company.
- Documents evidencing the identification of the pledger and the pledgee.
- Other documents as required by the registering institution. These may include for example a corporate chart showing the relationship between the ultimate investor and the vehicle it is using for the investment.

(Article 7, 2016 Share Pledge Measures.)

In most cases, an equity pledge can be registered instantly on submission of a complete set of application documents with the competent registrar (*Article 14, 2016 Share Pledge Measures*).

The AIC has no formal powers to conduct a review of the substance of the pledge or application documents, only that the proper procedure has been followed. However, some AIC offices will question or challenge pledges, in particular those that involve complicated equity or debt arrangements. Challenges are more commonly seen with AIC offices in less developed areas and smaller cities. For more information on the ways that local practice can affect the practicalities of registration, see *Local variations in registration and enforcement practice*.

COMMON FORMS OF SECURITY: MORTGAGE OVER REAL PROPERTIES

Significant assets such as real estate can be mortgaged. This can include among others:

- Office buildings.
- Residential houses.
- Factories.

- Land use rights.
- Buildings under construction.

A mortgage of real estate will only take effect on registration with the local real property administration or registration office as designated by county-level governments (*Article 187, 2007 Property Law* and *Article 42, 1995 Security Law*).

DOCUMENTS AND TIMELINE TO REGISTER A MORTGAGE OVER REAL ESTATE

To register a mortgage over real estate, bring the following to the registration agency:

- Application.
- The principal contract whose obligations are secured.
- The mortgage contract.
- The real estate certificate for the mortgaged property.
- Documents evidencing the identification of the mortgagor and the mortgagee.
- Power of attorney (if applicable).
- Other documents as required by the registering institution.

Though the real property registration agency does not have a formal power to conduct a substantive review of the subject mortgage, in practice, it may still challenge the application documents and the subject mortgage. The timeline and difficulty involved in completing the registration procedure may vary depending on the different registration agencies and the complexity of the principal documents involved. For more information on the ways that local practice can affect the practicalities of registration, see *Local variations in registration and enforcement practice*.

UNUSUAL FEATURES OF CHINESE REAL ESTATE LAW

Chinese real estate law does not conform to international norms in a number of important aspects, and it has a number of characteristics that are not found in jurisdictions such as the US, UK or Hong Kong. Lawyers qualified in other jurisdictions should particularly note the following:

- Real properties in urban areas and rural areas are subject to different legal systems in terms of ownership and land use rights, and mortgage rules of real properties in such different areas also vary. For example, land use rights in rural areas are generally not mortgageable (*Article 37, 1995 Security Law*).
- The ownership of buildings (including buildings under construction) is separated from the right to use the land on which they are located. However, a mortgage over either a building or the usage rights to the land on which it is constructed must be accompanied by a mortgage of the other (*Article 36, 1995 Security Law* and *Article 182, 2007 Property Law*).

In a transactional context, the lender's counsel should pay detailed attention to the results of due diligence into the real estate in the light of these characteristics. It may not be feasible to grant or to enforce a mortgage over a particular parcel of real estate. If it is not, lender's counsel should discover this as early as possible in the transaction and bring it to the attention of the lender. For more suggestions on how to address issues over certainty of security enforcement that arise during a transaction, see *Addressing uncertainties in enforcement*.

In addition to confirming whether a mortgage of ownership and land use rights is feasible, creditors should also check for pre-existing securities. Second mortgages are permitted (*Article 35, 1995 Security Law*), but some local real property administrative agencies may refuse to register another mortgage if a previous one has already been registered over the same property.

COMMON FORMS OF SECURITY: PLEDGE OF SIGNIFICANT INTELLECTUAL PROPERTY (IP)

Rights over intellectual properties such as trademarks, patents or copyrights can be pledged. A pledge over IP rights will take effect on registration with the competent government authorities (*Article 227, 2007 Property Law* and *Article 79, 1995 Security Law*).

Pledges over registered trademarks and patents are the most common. For these pledges, the competent government authorities responsible for registration are the **State Intellectual Property Office** (SIPO) (for pledge over patents) and the Trademark Office of State Administration for Industry and Commerce (Trademark Office) (for pledges over trademarks).

DOCUMENTS AND TIMELINE TO REGISTER A PLEDGE OVER IP

Different documents are needed to register a pledge over different kinds of IP. Typically, the following documents are required by SIPO or Trademark Office for the establishment of pledge over patents or trademarks:

- Application letter.
- The principal contract setting out the secured obligations.
- The pledge document.
- Parties' evidence of identity (for example, an ID card for an individual or shareholder registers for a corporate).
- Certificate evidencing ownership and registration of the relevant IP rights.
- Appraisal document or an agreement executed by the parties confirming the valuation of relevant IP rights.
- Power of attorney appointing the individual present to conduct the registration.

(*Article 7, Measures for the Registration of Pledge of Patent Rights 2010* (2010 Patent Rights Pledge Measures) and *Article 4, Provisions of the State Administration for Industry and Commerce on the Procedures for the Registration of the Pledge of the Exclusive Right to Use a Registered Trademark 2009* (2009 Registered Trademark Pledge Provisions).) The registration of pledges over IP can be theoretically completed quickly. For a registered trademark, the pledge is required to be registered on submission, subject to SIPO's confirmation that the applicant has submitted a complete set of registration documents. For a registered patent, SIPO should register the pledge within seven working days. In practice however, this process usually takes much longer. (*Article 6, 2009 Registered Trademark Pledge Provisions* and *Article 11, 2010 Patent Rights Pledge Measures*.)

COMMON FORMS OF SECURITY: SECURITY OVER OTHER ASSET TYPES

Equity pledges, real estate mortgages and IP pledges make up the bulk of security given in Chinese PE transactions. Depending on the business and assets of the target, other asset classes may also be available. As advisor to the investor, you should identify appropriate security targets based on the target's business in the course of due diligence and include them in the discussion of security as early in the

transaction as possible. This will reduce the chance that a new asset class will come to light amid a transaction, which is undesirable because it forces the investor to choose between raising the issue (and potentially upsetting negotiations), or foregoing an extra level of security. Many types of asset can provide useful additional security. These include tangible assets other than real estate (also referred to as movable assets), and also assets whose nature is fluctuating such as an account balance or stocks of raw materials.

MOVABLE ASSETS

Any physical item not prohibited from being mortgaged can be a movable asset. This category would for example include:

- Motor vessels.
- Aircraft.
- Ships and other vessels.
- Plant and machinery.

These can be mortgaged in the usual way. For a list of different types of movable property that can be secured this way and the registration authority in each case, see *Practice note, Taking security in China: Perfection of a mortgage*.

INTANGIBLE AND VARIABLE ASSETS (FLOATING CHARGE)

Since 2007 it has been possible to create security over wider classes of assets that are not fixed and tangible, including, for example:

- Fund units.
- Cash accounts.
- Depositary receipts.
- Accounts receivable.
- Raw material, work-in-progress and inventory stocks.
- Assets subject to a contingent interest (that is, assets that the security grantor has or will own, even if they have yet to take possession of them).

The *2007 Property Law* created two types of security to allow security over these intangible and variable assets:

- A floating mortgage can be granted over manufacturing facilities, raw materials, semi-manufactured goods and products the security grantor has already owned or is going to own. A floating mortgage becomes effective on execution of the mortgage agreement (that is, it is effective even without registration). It should however be registered with the local AIC to protect the creditor against any right in the mortgaged assets asserted by a bona fide third party acting in good faith (*Articles 181 and 189, 2007 Property Law*).
- A pledge can be granted over accounts receivable. A pledge of accounts receivable will take effect on registration with a competent credit rating institution (*Article 228, 2007 Property Law*).

The two new forms have yet to be widely accepted in PE transactions. This is largely due to practical challenges, for example, it can be difficult to supervise and enforce a floating mortgage. As a result, the internal risk control systems of many banks prevent them from accepting these forms of security in their lending practices.

COMMON FORMS OF SECURITY: THIRD-PARTY GUARANTEE

In addition to the various types of security provided over individual assets, it is also usual to obtain a guarantee of the secured obligations from (if such a party is not the direct obligor under the principal debt or obligation):

- The holding company.
- The ultimate controlling shareholder of the target.
- The target (and any subsidiaries if applicable).

For example, the target's holding company may grant a guarantee to the lending bank as security for the acquisition loan if such holding company is not the direct obligor, and the ultimate controlling shareholder may grant a guarantee to the investor to support the obligations under a valuation adjustment mechanism made by its subsidiaries or affiliates.

The *1995 Security Law* permits the creation of two types of guarantee:

- Ordinary liability guarantee
- Joint liability guarantee.

For a more detailed discussion of these different types of guarantee under Chinese law, see *Practice note, Guarantees (China): Overview*.

PE investors should require the guarantor to undertake a joint liability guarantee if possible. Under this, the creditor may directly demand the joint liability guarantor to assume repayment responsibilities if the obligor fails to fulfil its obligations once they become due.

UPSTREAM GUARANTEES

If a Chinese company provides a guarantee to secure the obligations of its direct or indirect controlling shareholder (an upstream guarantee), note that:

- If the company has multiple shareholders, then to guarantee the obligations of its direct or indirect controlling shareholder, the company must obtain the approval of 50% of the disinterested shareholders (*Article 16, 2013 Company Law*).
- The Chinese courts appear reluctant to support upstream guarantees given by companies in support of their shareholders' obligations under a VAM clause, due to its negative view towards the target's direct VAM obligation (for more information on these, see *VAM clauses in Chinese practice*).

DOWNSTREAM GUARANTEES

The principal stockholder and its affiliates, in particular the direct holding company of the target, should usually be willing to guarantee the obligations of the target company under the investment documents. The main purpose of this guarantee is to secure obligations such as any conversion rights included in the investment instrument, as well as put rights or valuation protection mechanisms that fall on the target.

A personal guarantee can be a useful way of concentrating the mind of a controlling shareholder on the importance of ensuring that it and the target continue to abide by the terms of the investment documents even after the investment has been made. Yet the strength of a personal guarantee as a motivating tool depends on its enforceability. When advising an investor on the security provided by a guarantee, it is good to stress this point and consider the implications. For example, it is common to obtain an offshore guarantee governed by Hong Kong law from a controlling shareholder. Such a guarantee is more valuable if the shareholder has easily identifiable assets in Hong Kong, which it can be enforced against, than it would be against a controlling shareholder who lives in a mainland province and whose assets are all held domestically (or held in another family member's name).

COMMON FORMS OF SECURITY: QUASI-SECURITY

Quasi-security is not a term that has a specific meaning in law. It is a generic description for arrangements that are not legally-recognized forms of security but that have the effect of conferring security in a commercial sense. Examples of quasi-security that are common in PE transactions include:

- A power of attorney to transfer specified assets to the secured party.
- A conditional option to acquire specified assets in favour of the secured party.
- Retention of title documents, such as real property certificates.
- Execution of undated transfer instruments. For example, in a debt plus call option arrangement (that is, one that replicates a convertible debt structure, as described in *Convertible securities in Chinese targets*), the parties may enter into an undated equity transfer agreement to secure the enforcement of the call option.
- Execution of an agreement to transfer ownership of the subject asset immediately, subject to a provision that the asset will be transferred back to the original owner once the secured obligations have been discharged in full.
- Escrow arrangement.

These techniques provide some protection for the secured party. They have the following disadvantages:

- The Chinese courts may decline to enforce a quasi-security if they are being used to secure an arrangement that is itself not supported or questionable by law (for example, a VIE structure).
- Company registrars and escrow agents are cautious of liabilities and are often unwilling to involve themselves in potentially contentious situations. Even when the circumstances are clear, it is common for them to refuse to carry out an instruction based on a pre-signed transfer instrument, especially if the obligor claims that there has been no breach (which an obligor usually will if the relationship has deteriorated to the extent of litigation).

They should therefore be used as a supplement to security arrangements, not as a substitute for it.

OTHER NOTABLE ISSUES

FORM OF SECURITY DOCUMENT

The forms of formal security require the parties to enter into a written security contract. This must include at least the following provisions:

- Details of the underlying debt, including its type, amount and due date.
- Scope of the secured obligations.
- Details of the secured assets.
- Enforcement events.

For example, the formal requirements for a mortgage contract are described in *Practice note, Taking security in China: Key provisions in a mortgage*.

Creditors typically also include in the security document that the target and its affiliates (including any holding companies or subsidiaries and the ultimate controlling shareholder) give customary representations and warranties. These include among others:

- Full and clean ownership over the subject assets.
- Free transferability of the subject assets.
- That all internal approvals and any relevant third party or government approvals have been obtained.

Does the security document need to be executed as a deed?

Practitioners from the UK, US, Hong Kong and other jurisdictions that recognize deeds as a separate form of contract from other conventional contracts should be aware that there is no separation between deeds and conventional contracts under Chinese law and there are therefore no special execution formalities to observe when executing a Chinese-law governed security agreement. For more information on the formalities that need to be followed for contracts in China generally, see *Practice note, Execution of contracts and documents: China*.

If security is being taken over assets in jurisdictions that do recognize the distinction, such as Hong Kong (for example, if security is being given over the assets of a Hong Kong based holding company), then the security document over those assets may need to be executed as a deed. This is something to check with local counsel wherever the assets are located.

Prohibited provisions

There is a general prohibition on including in a security contract a clause stating that the asset itself will be transferred directly to the creditor if the obligor fails to pay off its debt when it comes due (*Articles 186 and 211, 2007 Property Law* and *Articles 40 and 66, 1995 Security Law*), on the ground that the creditor may take unfair advantage over the obligor and security provider given the latter's presumably weaker position when a security document is executed.

SECURITY IN A DEAL STREAM

Security documents usually form part of the definitive agreements in a PE investment. Depending on the specific procedures involved for perfection and the deal timeline, the parties may request that perfection or registration procedures are carried out either as conditions precedent to closing or as post-closing matters. If a prior approval of the security is required from a governmental authority or any third party, this should generally be made a condition precedent so as to give greater certainty of closing.

DUE DILIGENCE

Usually, creditors (that is, the investor itself or its financing banks) shall use their due diligence opportunity to identify potential assets that could be used as security subjects and evaluate feasibility of taking a security interest over such assets. .

In addition, the creditors must also evaluate the value of security assets and the creditworthiness of the guarantor to ensure that the security that they are getting is appropriately large in relation to the size of the underlying debt or liability.

Chinese commercial banks are required to take a prudent approach when evaluating the subject assets, especially when intangible assets such as equity interest are involved (*Article 29, 2015 M&A Loan Guidelines*), and before lending will ask the investor questions to test the strength of the security. When carrying out due diligence into the target group, counsel to the investor should pre-empt these questions by investigating potentially securable assets and trying to ask as many of those questions itself as possible. These include, for example, details of the valuation of the assets and the existence of any security or quasi-security over them.

A simple list of due diligence request questions relating to assets can be found in *Standard document, Due diligence request (inbound M&A): China: Clause 6: Assets (excluding real estate)*.

Internal approvals

During due diligence, counsel representing the investor should check the articles of association of the company granting security to determine whether any internal approvals are required. Some companies cannot grant security without first obtaining the approval of the board of directors or the shareholders in general meeting.

If the company providing security has multiple shareholders and the principal obligor is the company's controlling shareholder, an approval by 50% of disinterested shareholders is required (*Article 16, 2013 Company Law*).

If the security grantor is a public company, additional internal procedures may apply (see *Grant of security by or over publicly listed companies*).

When representing the investor, also review any other documents that may set out internal procedures that the company is required to follow. For example, a company with multiple shareholders may be a party to a shareholders' agreement that sets out a specific procedure it must go through before granting security (it may also grant a consent right to other shareholders, as described in more detail in *Third party approvals*).

Third party approvals

As well as government and internal approvals, due diligence should also flush out any approval or notification rights contained in outstanding financing or business contracts of the security provider. When acting for the investor, look for any prohibitions on the grant of new security over the target's assets and for arrangements that could interfere with the enforcement of security (for example, change of control provisions that would be triggered by enforcement) in the contracts that the target discloses.

SECURITY IN OFFSHORE STRUCTURES, RED-CHIP OR ROUND-TRIP INVESTMENTS

As in other countries, some Chinese business owners choose to hold their domestically incorporated businesses through intermediary holding companies that are incorporated in a foreign jurisdiction. Typical jurisdictions are Hong Kong, the Cayman Islands and the British Virgin Islands. This structure is often called a "red-chip" structure, because it was initially developed in the context of listing China's largest companies (known as red-chips) on the Hong Kong stock exchange. When Chinese investors acquire a stake in a Chinese company using an offshore vehicle, this is also called "round-tripping", which describes the journey taken by the investment from China, to the offshore jurisdiction, then back to China again.

The main reasons that red-chip or round-tripping structures are used in PE investments include that:

This structure will facilitate the target company's future IPO at an offshore stock market such as Hong Kong Stock Exchange, NASTAQ, and New York Stock Exchange. While there are a number of pros and cons for a company to pursue an offshore IPO as opposed to a local IPO at the A-share market in Shanghai or Shenzhen, if a company has decided to list at an offshore market, it should generally adopt a red-chip or round-tripping structure.

China continues to operate some capital controls, although the scope of these is looser than was the case in the early 2000s. For an overview of China's capital control regime, see *Practice note, Foreign exchange control in China*. This structure allows the target company to access international investors with more flexible investment structures.

If the investment will leave the founders with a continuing stake in the business (that is, if it is a minority investment instead of a buyout), there are advantages to using an offshore holding vehicle instead of a Chinese joint-venture company. This is because Chinese laws governing joint ventures are less flexible and tend to favour the Chinese party. Jurisdictions are favoured that offer parties more choices in areas important to PE structures such as governance, how and when dividends may be paid and the criteria for returning capital to shareholders (for a general overview of the restrictions that apply to onshore joint ventures, see *Standard document, Equity joint venture contract (greenfield): China*).

Chinese shareholders are required to register with the competent office of **State Administration of Foreign Exchange** (SAFE) to set up an offshore holding company or make an investment towards an offshore entity (*Article 3,* Notice of the State Administration of Foreign Exchange on the Administration of Foreign Exchange Involved in Overseas Investment, Financing and Return on Investment Conducted by Residents in China via Special-Purpose Companies 2014 (2014 SPC Notice on Round Trip Investment)). Subsequent changes to that shareholder's shareholding will also generally need to be registered with a SAFE office (*Article 5, 2014 SPC Notice on Round Trip Investment*). In addition, if the Chinese shareholder is a Chinese company or corporation (as opposed to an individual), it will also generally need to go through the filing procedures with a competent **National Development and Reform Commission** (NDRC) office and a **Ministry of Commerce** (MOFCOM) office (*Articles 1 and 2,* Notice of the National Development and Reform Commission on Issues Concerning the Implementation of the "Administrative Measures for the Verification and Approval and Record-Filing of Outbound Investment Projects" 2014 and *Article 6, Administrative Measures for Outbound Investment 2014*).

If the target uses an offshore structure, then:

Help the client to find local counsel qualified in the jurisdiction of incorporation of the holding companies.

Ensure that any obligations secured against the target and its subsidiaries are also secured against the shares in the offshore holding companies. The form of security available will be generally governed by the law of the jurisdiction where the holding company is incorporated. It is therefore important to understand the legal requirements and rights to set up and enforce the security in this jurisdiction and the procedural steps that are involved in doing so. If necessary, the investor may consider obtaining a legal opinion from local counsel qualified in that jurisdiction, which will cover such relevant issues.

Check the up-to-date Chinese tax law and foreign exchange implications of remitting funds and returning capital between the target business and the holding company, and make sure the investor is aware of these and has addressed them in its financial models for the investment.

Pledge over equity in FIEs

Historically, if the target company is an FIE, in addition to registering with the securities depository and clearing institution or an AIC office:

The capital in the FIE must be fully paid-up (*Article 6, Certain Provisions on Change of the Equity Interests of the Investors of A Foreign-Invested Enterprise 1997* (1997 FIE Investor Change Provisions)).

An additional approval must be obtained from the competent MOFCOM office with which the target was originally

approved (*Article 5,* Measures for the Registration of Share Pledge with Industry and Commerce Administration Authorities 2008 (2008 Share Pledge Measures) and *Article 6, 1997 FIE Investor Change Provisions*).

In April 2016, the 2008 Share Pledge Measures was replaced by the 2016 Share Pledge Measures and the original requirement that pledge over equity interest of an FIE must be approved by the competent MOFCOM office has been removed. Though it is not clear whether the relevant provisions under the 1997 FIE Investor Change Provisions have also been abandoned, some of the MOFCOM and SAIC offices have interpreted the 2016 Share Pledge Measures in such a way that the MOFCOM approval requirement is no longer implemented. In fact, some of them go further and discontinue the capital contribution requirement in their recent practices, on the basis that the country's capital registration reform under the *2013 Company Law* has replaced the paid-in capital system with a subscription one (see *Practice note, Understanding the 2013 Company Law reforms: China*).

In any event, the investor should be aware that an approval requirement (or at least a filing for a limited scope of companies incorporated in the free trade zones in China) is nonetheless required on the transfer of equity interest of an FIE if such an equity pledge is ever enforced.

Cross-border security

Some PE investment structures involve security being given cross-border (that is, either an onshore company granting security of offshore obligations or the reverse) (see *Practice note, Cross-border guarantees: China*). Both types of security are subject to special rules under Chinese law that govern, among others:

- Foreign exchange registration.
- Use of proceeds.

In particular, the proceeds of a security over onshore assets cannot be used to acquire an offshore holding company if the major assets of the target group are located in mainland China.

GRANT OF SECURITY BY OR OVER PUBLICLY LISTED COMPANIES

Additional restrictions apply to the grant of security over the equity in, or assets held by, companies listed in China.

Pledges over equity in a listed company

The following restrictions apply to pledges over equity in a listed company:

- **Lockup restriction.** Pledged equity must generally be freely transferable. If shares in a public company are to be pledged, the parties must ensure that such shares will no longer be subject to any lock-up restrictions at the point that the pledge is enforced. Lock-up restrictions applicable to shares listed on the main board of the Shanghai and Shenzhen stock exchanges include, for example:
  - that shares issued before an IPO or before the incorporation of a joint stock company must not be transferred in one year after the IPO or incorporation (*Article 141, 2013 Company Law*);
  - shares held by controlling shareholder or actual controller may not be transferred within three years after the company's IPO (*Article 141, 2013 Company Law*);
  - shares held by directors, supervisors and senior management team members may not be transferred within one year after the IPO date or within six months after they leave their post (*Article 141, 2013 Company Law*). After the expiry of the one-year lock-up period, directors, supervisors and senior management team members who remain with the listed company may transfer shares not exceeding 25% of the total amount of such shares held by them for each year of their term, but must file all relevant information with the applicable Stock Exchange before making each such transfer (*Article 141, 2013 Company Law*); and
  - shares owned by foreign strategic investors (including those introduced during IPO, following public offerings, targeted offerings and share transfers or by similar means) are subject to a three -year lock-up from the date of acquisition of such shares (*Article 5,* Administrative Measures for Foreign Investors' Strategic Investment in Listed Companies 2005 (2005 Foreign Strategic Investment Measures)).
- **Rules that may interfere with enforcement.** The transfer of shares in a listed company is subject to rules mainly set out in the 2013 Company Law, the Law of the People's Republic of China on Securities 2014, regulations passed by the **China Securities Regulatory Commission** (CSRC), and the rules of the stock exchange where the company is listed. These include that, for example:
  - additional information disclosure requirements arise on the transfer of 5% or more of the outstanding shares of a listed company;
  - a mandatory tender offer may have to be made once a party acquires 30% of the outstanding shares of a listed company; and
  - the transfer of equity in a listed company to a foreign investor, which constitutes a strategic investment under the 2005 Foreign Strategic Investment Measures, is subject to the approval by the central MOFCOM.

Grant of security over major assets owned by a listed company

The following restrictions apply to grants of security over major assets owned by a listed company:

- **Additional corporate procedures.** Listed companies are subject to special procedures governing the provision of external security to a shareholder or third party (this includes the giving of a guarantee or the creation of a security interest over assets owned by the listed company).

  All forms of external security provided by a listed company shall be approved by the board of directors of the company or its shareholders' meeting, and the specific authorities and voting mechanisms are usually provided in the articles of associations of the listed company. The following forms of external security require approval by both the board of directors and the approval of shareholders:
  - within a year, the total value of assets granted security interest exceeds 30% of the asset value of the listed company;
  - listed company or its controlled subsidiaries provide additional security in excess of 50% (in the aggregate) of the listed company's audited net assets;
  - security is provided in relation to a principal obligor whose ratio of liabilities to assets exceeds 70%;

- any individual security is given in which the liability involved exceeds 10% of the listed company's audited net assets; and
- any individual security is given by the listed company in favour of its shareholder, ultimate controlling shareholder or any affiliate of the listed company.

(*Article 121, 2013 Company Law* and *Article 1, Notice of the China Securities Regulatory Commission and the China Banking Regulatory Commission on the Regulation of External Guarantees by Listed Companies 2005* (2005 Notice on Listed Companies Guarantees).)

- **Disclosure obligations.** When a listed company's board or shareholders approve the grant of a security, the listed company must disclose the authorising board or shareholder resolution, together with the total amount of securities outstanding over the assets of the listed company and its controlled subsidiaries (*Article 1, 2005 Notice on Listed Companies Guarantees*).

GRANT OF SECURITY OVER STATE-OWNED ASSETS

Chinese law is protective of **state-owned assets** (SOAs), and seeks to prevent them passing into private hands for less than they are *truly worth. A special set of rules applies to the transfer of ownership* of SOAs (this is described in *Practice note, Transfer of State-owned assets: China: What are the major procedures for the transfer of state-owned assets?*). The use and disposal of SOAs is supervised by the **State Asset Supervision and Administration Commission** (SASAC) and its local counterparts.

It can therefore be challenging to obtain valid security over the assets of an SOE. Even if a valid security can be obtained, enforcing security over SOAs (and as a result causing them to pass into private ownership) may become an inherently political action and potentially subject to challenge through non-legal measures. This is particularly the case if the investor is not Chinese (such as, for example, a US or UK private equity firm). This is not a reason not to take security over SOAs, but these potential risks should be brought to the attention of the investor.

OBTAINING A PLEDGE OVER EQUITY IN AN SOE

Generally, equity interest in SOEs can be pledged, yet this may involve special procedures with SASAC on the pledge establishment, in addition to various enforcement risks due to the special set of rules applicable to the transfer of an SOE equity interest. Except for a listed company (see below), it is not crystal clear whether a SASAC filing is required universally on the establishment of equity pledge involving an SOE. From risk control perspective however, such a filing is recommended, to avoid being challenged by SASAC on future enforcement.

If the SOE is listed, the pledge agreement should be filed with SASAC before being registered with the CSDC, and a pledge over such SOE equity:

- May only be provided to secure the liabilities of the SOE or its subsidiaries.
- May not exceed 50% of the total equity of the listed company held by the SOE shareholder.

(Article 8, Certain Opinions of the State-Owned Assets Supervision and Administration Commission of the State Council on Regulating the Acts of State-Owned Shareholders of Listed Companies 2009 and Articles 3 and 4, Notice of the Ministry of Finance on Issues Relating to the Pledge of State-owned Shares in Listed Companies 2001.)

OBTAINING SECURITY OVER ASSETS OF SOES

SOEs may not grant security to a third party if that would prejudice the rights of their shareholders (that is, the Chinese state) or creditors (*Article 30, Law on the State-Owned Assets of Enterprises 2008*).

SASAC does not state exactly what actions would be considered as prejudicing the rights of shareholders or creditors. It is safer to generally assume that a SASAC filing is required when taking security over the assets of an SOE, and it is generally good practice to obtain an appraisal of the assets over which the security interest is to be granted (*Article 4,* Measures for the Administration of Evaluation of State-Owned Assets 1991). This can hopefully resist subsequent challenges to the enforcement of the security on the grounds that the asset is being transferred at below its fair value.

LOCAL VARIATIONS IN REGISTRATION AND ENFORCEMENT PRACTICE

Many forms of security involve registration with, and sometimes approval by, different government authorities, as perfection procedures. For example, an equity pledge must normally be registered with the local AIC office.

Note that procedures with government agencies in China may vary significantly from place to place. The same request may receive different treatments from government agencies. They may have different procedures. They may also take different interpretations of their own powers of approval or review, or the documents that ought to be submitted to them as part of the review process.

Plan for this if registration or enforcement of a security will need to be carried out with government agencies, in particular in less developed areas or smaller cities. The most effective approach is usually to co-ordinate the client's and target's local knowledge and relationships, together with those of local counsel in the area, to make sure that before the transaction gets as far as signing or closing, it is already clear what local practice is at the competent government authorities. As part of this, it is helpful to engage the local authorities in the process as early as possible in the transaction.

LEGAL OPINIONS OVER SECURITY IN PRIVATE EQUITY TRANSACTIONS

PE investments generally require the approval of an investment committee. Most investment committees will not approve a transaction unless their deal teams obtain at closing a legal opinion that the security received by the investor is valid and enforceable. The proper person to give this opinion is local counsel qualified in the jurisdiction where the secured asset exists. This will usually mean obtaining opinions from Chinese counsel plus counsel in whichever offshore holding company jurisdictions have been used. Delivery of each relevant opinion should be a condition precedent to closing in the SPA.

The scope of the legal opinion may vary, but should at a minimum include that:

- The grantor of the security owns the subject assets.
- All necessary internal and external approvals have been obtained for the grant of the security.
- The security has been validly created.
- The security has been perfected, and any necessary government approval or registration has been obtained or made.
- The security may be enforced against the secured party in the event of a breach of the secured obligations.

- The grant of the security does not violate the term of any contract or other legal document by which the grantor is bound.

A legal opinion is not a substitute for meticulous due diligence. Some domestic Chinese PE funds do not customarily obtain Chinese-law legal opinions. This is partly because the system of legal professional indemnity insurance is not yet well developed in China. As a result it is not safe to assume that a small firm has adequate insurance to cover the loss that may be suffered by an investor as a result of relying on an incorrect statement in a legal opinion. Some funds also have concerns over the transparency or efficiency of the Chinese courts, particularly in less developed areas or smaller cities.

ADDRESSING UNCERTAINTIES IN ENFORCEMENT

The certainty of enforcement is likely to be one of the assumptions taken into account by a PE investor's investment committee when deciding to proceed with an investment. However, there is by international standards a relatively low certainty that security granted in China can be enforced. Even if a legal opinion to that effect is given, a prudent investor will not rely solely on the opinion.

The major enforcement risks in connection with taking security in PE investment lie in, for example:

- Challenges associated with the principal debt or obligations may in turn affect the effectiveness and/or enforcement of the ancillary security agreements. For example, the debt and call arrangement in the convertible securities structure, the VAM obligations by the target company, and so on. See *Security supporting convertible securities structure* and *Security supporting valuation adjustment mechanisms*.
- The subsequent transfer of secured assets on the security enforcement are subject to substantial government or other procedures, such as taking security interest over SOE equity or assets, security involving cross-border transactions or a contractual third party approval triggered on enforcement.
- Validity of pre-executed transfer documents (that is, quasi-security documents) under Chinese law that may raise questions as to the mandatory formality, fairness to the parties, truthfulness of the parties wills, or evasion of compulsory laws, among others.
- Policy trends or other practical challenges.

While there is no all-in-one solution to these potential risks affecting the enforcement of a security interest, the investors do have some choices that may help mitigate some of such risks in addition to a legal opinion from the counsel of the target company, for example:

- Use the diligence opportunities to identify the major assets that could be used as security subjects, with a careful assessment as to the feasibility and enforcement risks associated therewith.
- China's laws in connection with PE investments are evolving quickly, and the investors should always confirm with local counsel on the most updated laws and practices in connection with the various aspects of a security structure involved in a PE transaction.
- If the subsequent enforcement of a security (that is, transfer of the subject assets) requires a government procedure, the investors should make enquiries with the competent government authorities before the establishment of a security interest, and if necessary, try to obtain a filing or clearance from them even if such procedure is not mandatory at the stage of establishing a security interest.
- If commercially possible, try to take security over a wider range of assets with more flexible structures that would sufficiently protect the investments.
- Obtain special indemnifications from the controlling shareholder and/or the target company if the security interest cannot be duly enforced in the transaction documents or a side letter.

Even in cases where enforceability is doubtful, a significant role played by the security is to strengthen the investor's hand in negotiations with the founder over retrieving the investor's money from a troubled investment.

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