A question of trust

STEPHEN NORTON AND **CARMEN LAI** SAY THAT THE TRUST MODEL OFFERS UK CORPORATES A POWERFUL TOOL FOR FURTHERING THEIR CHINA INVESTMENTS.

When David Cameron visited Barack Obama in March, he presented the US president with a table tennis table produced by Dunlop. A spokesman for the prime minister said: "Founded in 1886, Dunlop is a truly British company, which operates in over 70 countries. It is the most successful sports brand of the 20th century, and a fitting gift for the occasion as we approach the London 2012 Olympics." Unfortunately, although the table was "designed and branded" in the UK, it was actually made in China.

A great many things are, of course, made in China. Last year the country ended the century-long dominance of the US in world manufacturing, accounting for 19.8% of the world's production of goods compared with 19.4% chalked up by the US. That, plus China's booming economy, makes it an attractive place for UK corporates to buy into.

In a cross-border acquisition or strategic investment, whether for part or all of a business, the trust model can be used in a multitude of different ways for the benefit of both seller and investor. A trust enables the transaction to proceed or gives one or both of the parties the assurance that they would not have otherwise. This may be particularly important if the investor is investing in another country for the first time and wishes to have the assistance of a reputable third-party provider of trust services.

Treasurers of companies seeking to invest in China are likely to be aware already of the value of such services in the light of their corporate activity in more familiar jurisdictions, whether in providing practical solutions to commercial problems, addressing regulatory issues or future uncertainty. Now for the first time such services are available to foreign investors in mainland China under the country's trust law through Law Debenture's co-operation agreement with Jiangsu International Trust Corporation.

Law Debenture is a trust and escrow services provider, while JSITC is China's fifth largest trust company and 98%-owned by the government's Jiangsu Guoxin Investment Group.

China is changing fast. The middle class is growing in size and prosperity, and over 50% of the population now live in cities. It has an increasing number of private sector businesses that are keen to expand. One recent survey estimated there are over 2,000 companies in China that want to list on the stock exchange.

However, China is also considered to be a hard market for foreign businesses to enter. Lack of government support, restrictive practices and cultural issues and – above all – the regulatory environment are seen as significant barriers to entry. Foreign investment in some key sectors, such as financial services, internet businesses and real estate, is still restricted and may even be prohibited. Even in industries and sectors earmarked for investment, the process involved in setting up an onshore presence is complex and time-consuming. That said, the potential is huge and few corporates focused on growth can afford to ignore it.

Given this business climate, we believe that UK corporates investing in China require the following:

- protection against future uncertainty or risk where possible;
- retention of key staff in the target business;
- the ability to comply with regulation without compromising underlying commercial objectives as far as possible; and
- risk minimisation, particularly where joint ventures are concerned.

While UK corporates will be experienced investors in their existing markets, established business practices in China and its underlying regulatory environment are likely to be different from what they are used to. Our experience suggests that treasurers may wish to consider the following scenarios when contemplating investing in China.

ACQUISITION WHERE THE CONSIDERATION IS HELD BACK – ESCROW ACCOUNT

■ **Requirement**. A foreign company acquiring or investing in a business in China may be required to place the investment funds in a segregated bank account pending regulatory approval. Alternatively,

an investor may wish to hold back some of the payments due to the vendor until certain conditions are met at a future date – perhaps warranties need to be satisfied or operating profits must increase by 10% in the next two years. In each case neither party wants the other to have control over the money representing the deferred payment until the outcome has been settled to their satisfaction.

■ **Solution**. The practice in China has been to place funds with a notary or to use a bank account under the dual control of both parties. Now, however, as is standard practice with Law Debenture in the UK, JSITC can act as escrow agent for cash, documents and title documents, pending the fulfilment of warranties.

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ACQUISITION WITH REGULATORY ISSUES – VOTING TRUSTS

■ **Requirement**. Depending on the sector involved, regulations in China may place a limit on the maximum percentage of the shares in a Chinese company that may be held by a foreign investor. This may be to limit the voting rights of foreign investors in such companies so as to restrict their influence on the company's business. Equally, other authorities in China may wish to limit the voting rights of foreign investors in specific Chinese companies.

In such cases voting trusts can be used to make a commercial agreement possible between the owners of a company and the outside investor whose investment or technology the owners wish to use in return for an agreed share of the profits but a correspondingly lower share of the voting rights.

■ **Solution**. The shares that exceed the permitted holding by a foreign investor are transferred to JSITC as trustee and held under a declaration of trust. Under the terms of the trust all of the economic benefits, such as dividends, pass to the foreign investor but the underlying voting rights would be exercised by the trustee in accordance with the instructions received from someone approved by the regulator. This allows the foreign investor to acquire the share of the regulated business it wants without breaching regulations that limit potential voting rights.

Law Debenture has undertaken this role for numerous companies in the UK, and used the voting trust model in Hong Kong to facilitate an investment by Anheuser Busch in China's Tsingtao Brewery a few years ago when Tsingtao had H shares listed in Hong Kong. Anheuser wanted to acquire 27% of Tsingtao; it duly acquired 20% and the remaining 7% was held by Law Debenture as a share trust. Under the terms of the trust any dividends on the 7% held by Law Debenture would be transferred to Anheuser, and we would only exercise voting rights as directed by the board of Tsingtao, failing which no votes would be cast.

RETAINING KEY STAFF – EMPLOYEE SHARE TRUSTS

■ **Requirement**. Where a foreign investor is acquiring a controlling stake in an existing business in China or setting up a new business, it will be essential to retain and motivate key staff, particularly in the early stages of ownership. The same might also apply where a new employer wished to incentivise staff in advance of an initial public offering (IPO).

■ **Solution**. Shares in the company that is acquired are transferred to JSITC as trustee to be held for a defined period of time on trust. They would then be released to the relevant employees as beneficiaries of the trust, but only if specified conditions such as profit targets are met or if they remain employees of the company after a specified period. Sometimes such shares will be distributed to employees free of charge, or they will be entitled to receive them at a discounted price below market value.

JOINT VENTURE WITH A WEAKER PARTNER – SHARE TRUSTS

■ **Requirement**. A foreign company (FCo) wishes to form a joint venture company with a Chinese company (CCo) but is concerned that its investment in the joint venture could be jeopardised if CCo became insolvent. In such circumstances FCo would wish to be able to buy out CCo's interest in the joint venture quickly and on the basis of a predetermined formula rather than have to negotiate with the liquidator of CCo and/or compete with other potential and competing purchasers for the shares in the joint venture.

■ **Solution**. Under a shareholders' agreement relating to the joint venture, if either company becomes insolvent then the other will be entitled to exercise a call option over its shares in the joint venture at a predetermined price. So that the call option can be exercised without fail or challenge (any liquidator would be bound by its terms), the shares of each company in the joint venture are transferred to JSITC and held in separate trusts. Each company is given a power of attorney allowing it to exercise all its rights in relation to the shares held for it, while the other company is appointed as its delegate to operate the power of attorney given by the trustee under the trust. In this way, FCo obtains the protection that it requires.

UNFAMILIAR TERRITORY China is a dynamic market offering considerable opportunities, but it operates quite differently and at different levels from the environment many UK corporates are familiar with for cross-border M&A or strategic investments. However, rather like the table tennis table presented by the prime minister, Law Debenture can offer solutions designed, branded and developed in the UK – and implemented in China.

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