How a Change of Control Provision Operates in a Cross-Border Transaction

a comparative legal analysis between PRC and Australia

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Outbound investment; cross-border transactions

Introduction

While there is no standard to universally define a change of control, it usually occurs when the ownership or substantial assets of a target company, is materially changed, directly or indirectly. The way to determine such a change varies and can be defined by the laws under a jurisdiction, or through contractual agreements between parties. Things will become more complicated or even uncertain when two or more different jurisdictions are involved, since how to determine a change of control will be intricately affected by different legal definition and judicial interpretation under those jurisdictions.

Normally, a change of control provision is often due to a concern that the other party may be acquired by a competitor. Such provision is included to allow remedies for one party to have a right either to terminate the agreement or to adjust certain provisions thereof, such as the price or percentage of the shares in the target company, or even a forced sale of shares owned by the party that triggers a change of control.

Since the implications resulting from the change of control are serious enough for buyers to suffer a severe economic loss, or even a strategic failure that could possibly lead to commercial disputes, it is imperative to draft the change of control provisions in a way to best protect the buyer's interests by taking into consideration the following factors, on a case by case basis:

- Definition of a change of control and its exceptions;
- Uncertainty whether a change of control is triggered due to different jurisdictions;
- Possible consequence caused by a change of control;
- Enough time for adapting a change of control; and
- A time limit for the party exercising its rights to remedies, if any.

This client alert, by drawing upon the experience from a recent cross-border transaction between two companies from PRC and Australia, examines how the change of control issue operates as well as provides viable solutions to prevent potential uncertainties resulting therefrom, if not conflicts or disputes, which, will probably shadow the transaction.

Is there a change of control?

1. What is “control” in PRC

This is a threshold issue that probably varies depending different jurisdictions, and it is therefore necessary to know what laws govern the agreement in which the control is defined and, to property draft the change of control provision in an agreement, by taking into consideration of impacts that different judicial interpretations could possibly bring about.

From a legal perspective, China and Australia each has different views on the definition of the control.

In PRC, “control” of the company is defined in “a controlling shareholder” under the Company Law of PRC. A controlling shareholder, generally through two ways, controls a company: 50% or above shareholding, or voting rights that have a significant impact on the resolutions of the shareholders' meeting, if the threshold of a 50% shareholding is not met. Additionally, PRC Securities Law and relevant regulations of initial public offerings (“**IPO**”) apply a similar approach to determine whether a publicly listed company in China is controlled, if any of the following events occurs:

(1) Voting rights exceeds 30%;
(2) Voting rights can determine more than half of the board; or
(3) Voting rights or other powers that can exert practical influence or substantial impacts to actually control the company.

2. What is “control” in Australia

In Australia, “control” is defined not only by an above-50% shareholding or voting rights, but it tests capacity (“**Controlling Capacity**”) to determine the outcome of decisions about financial and operating policies of an entity. Under Section 50 AA of Corporations Act 200 Australia, the Controlling Capacity is mainly tested by the following factors:

(1) the practical influence the first entity can exert (*rather than the rights it can enforce*); and

(2) any practice or pattern of behaviour affecting the second entity’s financial or operating policies (even if it involves a breach of an agreement or a breach of trust).

(3) The first entity *does not* control the second entity merely because the first entity and a third entity jointly have the capacity to determine the outcome of decisions about the second entity’s financial and operating policies.

Accordingly, the Controlling Capacity does not always and solely come from legally enforceable rights, but rather, it could be tested with other considerations such as past practices and patterns of behavior. This is, however, debatable since two precedents from Australian Supreme Courts interpreted that the Controlling Capacity *must* come from a legally enforceable power.

In *Mount Edon Gold Mines (Aust) Ltd v Burmine Ltd* ("**Mount**"), White J of the Supreme Court of Western Australia has ruled that Burmine Ltd with a 38.5% shareholding does not control Mount Edon Gold Mines (Aust) Ltd: "…[I] find that practical or de facto control, in the absence of any such legally enforceable power, *does not* suffice to establish the relationship of holding company and subsidiary, pursuant to s 46(a)(i) of the Corporations Law, whatever other effect such measure of control might have. It is *not* sufficient, in my opinion that, as a matter of commercial practice, possession of a substantial percentage of the shares of a company, *being less than 50 per cent*, will ordinarily be enough to determine the result of an ordinary resolution at a general meeting of a company."

In *Bluebird Investments v Graf* ("**Bluebird**"), Santow J of the Supreme Court of New South Wales agreed with the conclusion reached in Mount:"…[T]his ordinarily connotes something intrinsically more durable and binding than an adventitious voting coalition, not reinforced by any legally enforceable arrangement. Such a coalition would be readily capable of changing at each shareholder meeting, providing additional reason for avoiding such a test falling short of legal enforceability, the language were clear." In *Bluebird*, two following tests were mentioned in the judgment:

(1) "The Voting control" test; in a position to cast, or control the casting of, more than one-half the maximum votes that might be cast at general meeting; and

(2) "Control of the composition of the board" test; by the exercise of a power, with or without the concurrence of any person, be able to appoint or remove all or a majority of that Board."

3. Uncertainties caused by different jurisdictions

As mentioned in the beginning, uncertainties will arise when a change of control event is governed and construed by the law in one jurisdiction, while the occurrence of such event is in another. The basic principle and methodology to clear these uncertainties is to apply the governing law to the facts that have occurred in another jurisdiction, which could determine if a change of control arises in accordance with the governing law.

The difficulty to apply the governing law to determine if a "control" exists in a different jurisdiction is the interdependence of legal interpretations from two different jurisdictions for the same issue or matter. In addition to applying the governing law, the legal facts where the change of control occurs need the laws thereof to draw a conclusion.

Therefore, the uncertainties will remain if two different jurisdictions have irreconcilable different views of defining "control". For example, in a typical cross-border transaction, the agreement could be governed by Australian laws but the alleged change of control event occurs in PRC, or vice versa. The case is even more complicated when a publicly listed company is involved, either on the side of buyer or seller. Take the controlling the composition of the board as an example: in Australia, the composition of the board is controlled if it passes the test in the *Bluebird* or satisfies Section 47 of Corporations Act 200 Australia. In China, however, the highest authority of a company is shareholders' meeting or a general meeting if the company is publicly listed.

4. Has the "control" changed

There is a variety of ways to trigger a change of control in a business transaction, either at law or by agreement.

(1) One of the most common ways for a change of control clause to be triggered is through mergers and acquisitions (M&A). During the M&A process and the negotiation period, it's important to consider the impact of the change of control on debt in both the target and the acquirer, as well as executive compensation arrangements in both companies.

(2) Another way to trigger a change of control is through a sale of all or substantially all of a target company's assets. Sometimes, during reorganizations, consolidations or other events mutually agreed by parties, a change of control could be triggered if more than 50% of the board members change, or a change in shareholders who have the right to elect more than 50% of the board.

(3) Parties to the agreement, of course, may agree upon many other circumstances that could trigger a change of control as long as such an agreement is not in violation of applicable laws that governs the agreement. For example, a change in management may also be deemed as an event triggering a change of control, if the management team of the target company is so crucial or unique that it may be difficult, if not impossible, to replace the management team. This usually applies to a situation when a target company's business is heavily relied upon the management team, such as a company that is venture capital funded.

Exceptions to the change of control

Depending on what business goals are for the parties to the agreement, they can carve out circumstances that do not trigger a change of control event so that the parties can avoid consequences resulting therefrom.

The exceptions normally include the following:

1. For the purpose of reorganization or restructuring, any merger or acquisition with an affiliated company;

2. Any merger, reorganization, business combination or consolidation less than 50% of the

combined voting power of the voting securities of a company;

3. A change of control event that is expressly permitted by the highest authority of a company in its sole discretion, e.g. the board or shareholders' meeting;

4. Where prior consent or wavier obtained from the other shareholders; or

5. Other circumstances mutually agreeable to parties, which may be exempted from the change of control, as long as such exemptions are not in contravention with the governing law.

The above exceptions allow the party triggering the change of control be immune to the potential implications caused thereby.

Possible consequences

Laws or precedents normally do not stipulate specific consequences that a change of control brings about. Parties may, however, agree upon the following by adding provisions in their agreement to guard against the change of control:

1. Material breach of the contract; if one party commits a material breach, the compliant party will be remedied in a way mutually agreeable in the agreement, such as compensation or damages;

2. Early termination of the contract; parties can walk away from the deal prior to expiration of the contract without liability should a change of control event occur.

3. Other consequences that may vary depending on the parties' specific commercial needs or the type of contract, including, but not limited to the following:

    (1) provisions that allow more flexibility for employees to leave the company, if the ownership of the company is crucial to the management or key personnel; or

    (2) a forced sale of the shares owned by the party triggering the change of control to the other compliant parties, the purpose of which is to either protect the integrity of the company, or the scarcity of the properties owned by the company, such as natural resources.

Lastly, parties may choose to enforce any of the above as they see fit, during the term of the contract or a certain period thereafter. It is thus necessary for parties to put a time limit on seeking remedies to a change of control event, or the rights thereof are waived otherwise.

Conclusions and suggestions

The change of control could become a dealbreaker for a transaction, or result in undesirable consequences for the parties thereto. It is therefore advisable that, during negotiation of the transaction and prior to execution of the agreement, the stakeholders and their legal counsels should not only be aware of the consequences caused thereby, but design a sound mechanism to mitigate such consequences.

A cookie-cutter approach to draft the change of control provisions in an agreement should be avoided. Various considerations need to be taken into account on a case-by-case basis when such provisions are drafted, e.g. how the interplay of the change of control among various jurisdictions affects the legal conclusion.

As far as a change of control provision is concerned, we offer the following suggestions in order to help parties in a transaction, especially an international one, set up a mindset that the devil is in the detail.

1. The general methodology and approach

In a general sense, it is important to know how to tackle the change of control issue in the following order,

(1) to determine what is control and if such control is changed;
(2) to make exceptions to the change of control, either at law or via agreement; and
(3) how to mitigate the consequences resulting from the change of control, from both legal and business perspective.

2. Know the laws in all relevant jurisdictions

More importantly, for the purpose of serving the best interests of parties to the agreement, the legal counsel needs to know what constitutes “control” under respective jurisdictions, and to identify any possible conflict of laws arising from these jurisdictions, so that they can draft the change of control provisions and their exceptions in a way to precisely address this thorny issue and effectively prevent potential conflicts.

If necessary, it is advisable to engage a local counsel from respective jurisdictions to work with the lead counsel in an international business transaction, so that they can together figure out a change of control provision to best protect the stakeholder’s interests.

3. Time constraints

A change of control clause without a time constraint is inherently uncertain and could be detrimental to the transactions.

If a party intends to terminate an agreement due to a change of control, it is crucial to avoid taking unnecessarily lengthy steps whose effect is to affirm the continuance of the agreement after that party becomes aware of the change of control and within the time limit (if applicable), since it may be held to have waived its rights.

If a party is more likely to trigger the change of control for any reasons whatsover, it is better to impose a time restriciton upon the change of control provision in the transaction documents, as this provision will help the party have more flexibility to cope with consequences resulting from the change of control events.

Contact

If you have any questions about this client alert, or if you would like to discuss how recent changes in Chinese law may affect your business, please call or write:

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