

How to Structure a Return Guarantee that Survives an IPO for a Pre-IPO Private Equity Investor

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Introduction

A return guarantee is a valuation adjustment mechanism generally arranged by an institutional investor with a substantial shareholder of the invested company (such as the controlling shareholder) with the objective of securing a specific return (for instance, when shares reach a target price) at which the institutional investor aim to divest following listing of the company. Under this arrangement, any difference between

the realized return upon divestment and the target return is to be compensated by the listed company and/or the substantial shareholder to the institutional investor.

Alternatively, in a comparable arrangement, the listed company and/or the substantial shareholder may provide a put option to repurchase the shares of the listed company held by the institutional investor at a predetermined price.

Restrictions on Return Guarantee Agreements outlined in the Pre-IPO Investment Guidance:

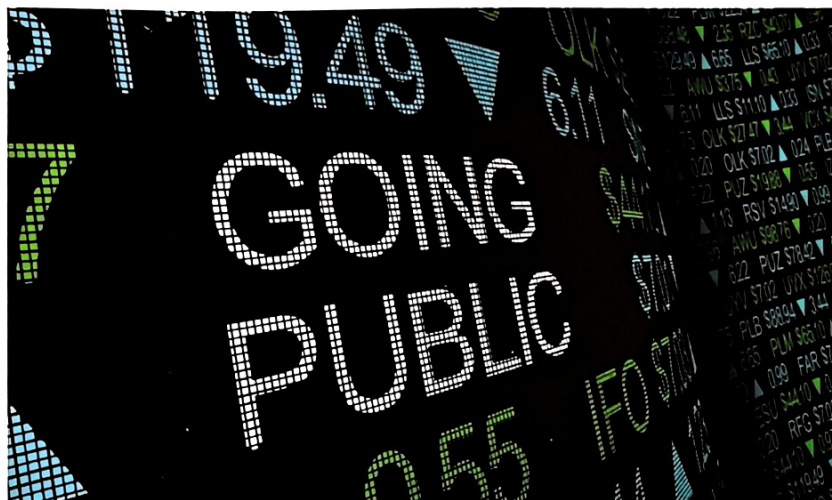
Pursuant to Rules 2.03(2) and 2.03(4) of the Rules Governing the Listing of Securities ("Listing Rules") on The Stock Exchange of Hong Kong Limited ("SEHK"), the issuance and marketing of securities must be conducted in a fair and orderly manner, and all holders are to be treated fairly and equally.

As detailed in Paragraph 11 of Chapter 4.2 of SEHK's New Listing Applicant's Guide (May 2024), Pre-IPO Investments Guidance, any special rights that are not extended to all shareholders or fail to comply with the Pre-IPO Investments Guidance must be amended or terminated before the listing process. These rights, further outlined in Paragraph 16, including those associated with convertible instruments such as convertible bonds, are considered special and are subject to the regulations outlined in the Pre-IPO Investment Guidance.

The Pre-IPO Investment Guidance stipulates that all non-compliant special rights attached to Pre-IPO investments should be terminated before the listing takes place. This entails, for instance, the prohibition of any financial compensation from the listed company, especially those directly linked to share prices or market capitalization (see "Financial Compensation", Appendix 1 below), as well as any provisions for price adjustments based on discounts from the IPO price or market capitalization (see "Price Adjustment", Appendix 1 below). Such adjustments should not, after the listing, be fulfilled by the listed company or controlling shareholders, nor by the listed company and/or its controlling entities to institutional investors.

Fundamentally, clauses guaranteeing returns directly linked to market values or stock prices after the listing, whether offered by the listed company or its controlling shareholders, are not allowed according to the Pre-IPO Investment Guidance. This prohibition stems from concerns that such clauses are unfair and non-compliant with public policies underlying the Listing Rules.

In any event, such special rights must be disclosed in the draft prospectus submitted with the listing application. Non-disclosure of such agreements in the prospectus could be deemed a breach under the Listing Rules and/or the Companies (Winding-up and Miscellaneous Provisions) Ordinance (Chapter 32 of the Laws of Hong Kong) for misrepresentation and misstatements. Additionally, it may constitute fraudulent



misrepresentation which induces others to invest, leading to potential market misconduct and unfair prejudice against the rights of other shareholders of the company.

Legal Status of Return Guarantee Agreements If Not Disclosed in Prospectus

Under Contract Law

A pre-IPO investor may have difficulties in enforcing a return guarantee agreement which is not disclosed in the prospectus.

Essentially, if a return guarantee agreement is signed by both parties in a duly authorized manner, it should be considered legally enforceable, binding on all involved parties.

Nonetheless, exception to this general rule exists in the case of illegality, where a claimant cannot pursue a claim arising from a contract with certain unlawfulness, and the defendant can raise "illegality" as a defense. Non-disclosure of a return guarantee agreement in the prospectus may render the agreement unlawful for violation of listing requirements.

The enforceability of a return guarantee agreement involving institutional investors against a listed company and/or related parties hinges largely on whether the agreement is materially tainted by elements of illegality under *Patel v Mirza*¹, such as the investor's participation in the

non-disclosure of the agreement in the prospectus.

The Hong Kong Court or arbitral tribunal may also consider other factors such as fairness among all the investors in the public listing, damage to the interests of public investors and minority shareholders, and incomplete or misleading disclosures affecting the listing process, when determining whether to enforce a return guarantee agreement under civil claims brought by institutional investors as claimants against listed companies, controlling shareholders and/or related parties, considering the defense of "illegality" raised by the defendants.

Under the Listing Rules: Prospectus Disclosure Requirements

Rule 2.13(2) of the Listing Rules stipulates that all information contained in the issuer's documents must be accurate and complete in all material respects, and not be misleading or deceptive. Furthermore, Rule 2.03 outlines that the Listing Rules aim to establish standards for market acceptance, including:

- The issue and marketing of securities is conducted in a fair and orderly manner and that potential investors are given sufficient information to enable them to make a properly informed assessment of an issuer, and in the case of a guaranteed issue, the guarantor and of the securities for which listing is sought;

¹ [2016] UKSC 42



- investors and the public are kept fully informed by listed issuers and, in the case of a guaranteed issue, the guarantors of material factors which might affect their interests.

According to Paragraph 10 of the Pre-IPO Investment Guidance, the listing document must include the following information:

- The beneficial owners and backgrounds of each pre-IPO investor, as well as their relationships with the applicant and/or any connected persons of the applicant.
- Details of any significant special rights granted to pre-IPO investors that will survive listing, explaining how these rights comply with Rule 2.03(4) of the Listing Rules and the principles outlined in the section on "Special Rights of Pre-IPO Investors" of the Pre-IPO Investment Guidance.
- Confirmation by the sponsor that the pre-IPO investments are in compliance with the Pre-IPO Investment Guidance and the basis for such confirmation.

If institutional investors engage in return guarantee agreements with the listed company and/or controlling shareholder that are not permitted by the Listing

Rules or Pre-IPO Investment Guidance, this constitutes a violation of the Listing Rules and the Pre-IPO Investment Guidance, including but not limited to the requirements of Rules 2.03(2) and 2.03(4) of the Listing Rules regarding the fair and orderly conduct of security issuance and marketing, the requirement for fair and equal treatment of all holders of listed securities, and the requirement under Rule 2.13(2) of the Listing Rules that prospective investors are provided with sufficient information to make a comprehensive assessment of the issuer and the securities being sought for listing.

If the Listing Committee finds there has been a breach of the Listing Rules by any of the parties named in Rule 2A.09, it may take relevant measures as it thinks fit, that range from issuance of a private reprimand to a public statement, or in the case of serious breach, suspend trading in the listed issuer's securities or any class of its securities.

Under the SFO: Market Misconduct

The Securities and Futures Commission of Hong Kong ("SFC") implements the Securities and Futures Ordinance ("SFO") (Chapter 571 of the Laws of Hong Kong). Under sections 280 and 304 of the SFO, a transaction is not void or voidable by reason only that any market misconduct has taken place in relation to or as a result of it. Even if a return guarantee agreement involves market misconduct violating the Ordinance, it does not automatically invalidate the agreement by virtue of the SFO.

However, it is important to note that under section 213 of the SFO, if the SFC believes that any person has contravened, or aided and abetted others in contravening any provision of the SFO, and such contravention has been committed, is being committed, or may commit, the SFC can apply to the Hong Kong court for injunction and other orders.

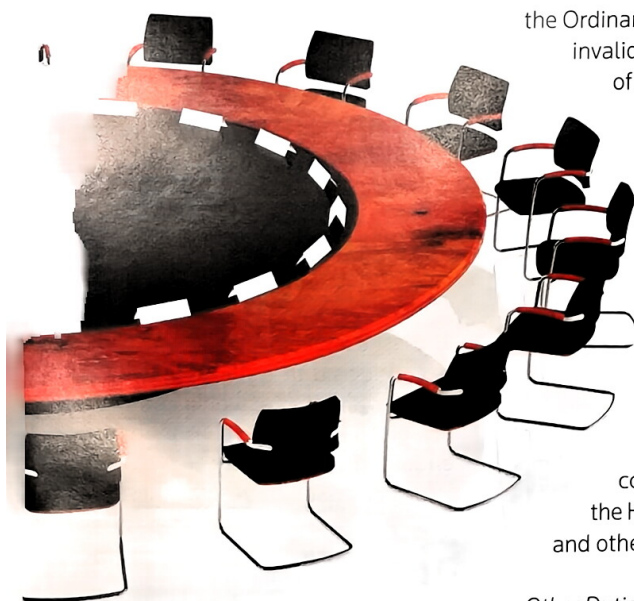
Other Duties: Directors' Fiduciary Duties

Directors have the duty to act in the best interests of the company, act in good faith, to act for the benefit of the members as a whole and for proper purposes, and to avoid conflict of interests. Allowing, inducing, or approving a return guarantee agreement to a shareholder may breach these duties, resulting in unfair treatment and harm to other shareholders.

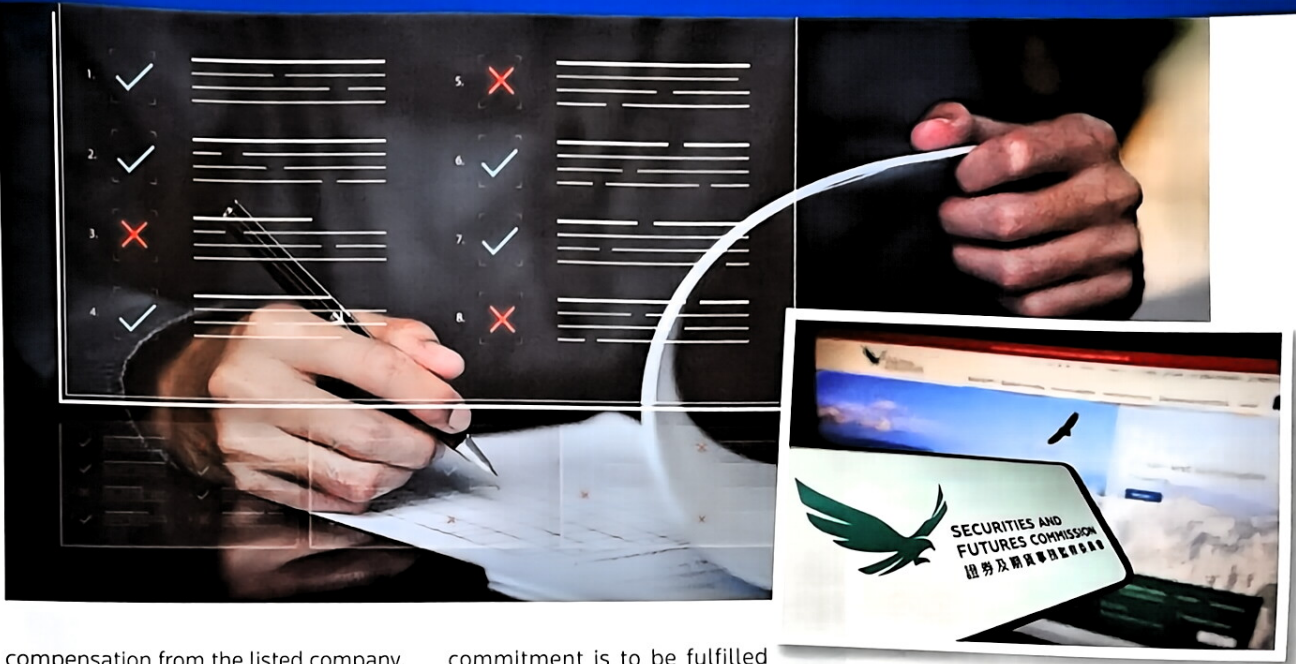
When evaluating such agreements, the court might consider multiple factors, including whether and how they impact fairness among investors in public offerings, harm the interests of the public and minority shareholders, and induce investments based on incomplete or deceptive disclosures. The court may also take into account instances where any pre-IPO investor knowingly engages in illegal or unlawful activities.

In cases where institutional investors nominate directors to the company's board, and these directors are responsible and involved in reviewing the prospectus, the institutional investors could potentially be implicated in any false or misleading disclosure in the prospectus².

In a situation where a return guarantee agreement is deemed unlawful, for instance, due to inadequate disclosure by a listed company in its prospectus, the SFC is empowered to initiate legal action under the SFO. In cases of suspected breaches, especially those related to market misconduct like misleading disclosure that leads to transactions, the SFC has the authority to seek appropriate court orders. These may involve declaring the return guarantee agreement contract between the listed company and/or the controlling shareholder on one part and the institutional investor on the other as void, prohibiting the listed company and/or controlling shareholder from compensating the institutional investor, rescinding relevant contracts to restore the parties to their pre-transaction positions (including returning funds to the listed company and/or ultimate controller), and potentially mandating



² *Securities and Futures Commission v Qunxing Paper Holdings Co Ltd* (No 2) [2018] 1 HKLRD 1060



compensation from the listed company, controlling shareholder, or institutional investor to other affected shareholders if they are found to have induced or aided such violations of the SFO.

Liability Under the CWUMPO: Misrepresentation or Misstatement in Prospectus

Misrepresentation or misstatements in a prospectus can result in civil and/or criminal liabilities under sections 40 and 40A of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32 of the Laws of Hong Kong).

Fraudulent misrepresentation inducing others to invest money can also result in civil and/or criminal liabilities under Sections 107 and 108(1) of the SFO.

Structuring a Return Guarantee Agreement

According to Paragraph 12 of the Pre-IPO Investment Guidance, rights granted from one shareholder to another or agreements between shareholders (including controlling shareholders) are considered private arrangements and are generally not subject to the restrictions of the Pre-IPO Investment Guidance.

It appears that the permitted arrangements for price adjustments that may survive listing in the context of pre-IPO investments involve specific conditions: (1) the arrangements are not linked to the share price (offer price) or market value of the shares, and (2) the

commitment is to be fulfilled or paid by the controlling shareholder.

SEHK allows return guarantee arrangements between the controlling shareholder and a pre-IPO investor. Such return guarantee agreements can be based on parameters unrelated to share prices or market value of the shares after listing, such as a fixed rate of return calculated through an agreed formula based on the investment amount or the performance metrics of the listed company.

Negotiations between the controlling shareholder and the institutional investor would generally involve agreeing on specific rates of return or non-price performance guarantees. Such negotiations can be time-consuming, and the outcome may carry high risks, especially when estimating for the value of high-growth companies post-listing. Nevertheless, within the current regulatory remit, a return guarantee that survives the listing may be structured.

In the vast majority of cases disclosing pre-IPO investment with special rights to institutional investors, the special rights would not survive the listing.

In a limited number of cases, pre-IPO investors were able to have special rights on returns guaranteed by the controlling shareholders which survived after the listing: for instance, First Service Holding Limited (Stock Code: 2107); Tycoon Group

Holdings limited (Stock Code: 3390).

Certain Non-cash Compensation Mechanisms are Generally not Allowed

Non-cash compensation mechanisms may take the form of compensation in the form of listed company shares (to be provided by the controlling shareholder to the pre-IPO investor), of a conditional put option granted by the controlling shareholder to pre-IPO investor for the investor to put the shares to the controlling shareholder.

In the case of compensation in shares, while theoretically the controlling shareholder can compensate investors with shares in the listed company, this arrangement may be viewed as granting the pre-IPO investor future entitlement to listed shares at a cost below the offer price, thus conferring special rights not extended to other shareholders. SEHK may disallow such an arrangement due to fairness considerations.

As for the grant of a conditional put option, it is explicitly provided in the Pre-IPO Investment Guidance that redemption, repurchase and other divestment rights (see "Divestment Rights", Appendix 1 below) must be ceased before the listing application form submission, and such rights include options granted by a controlling shareholder to a pre-IPO investor. Therefore, establishing a

conditional put option where investors can request the controlling shareholder to repurchase the listed company's shares after listing if a specified trigger condition is met would contravene the Pre-IPO Investment Guidance.

SEHK would be concerned about pre-IPO investments with guaranteed return linked to the IPO price, market capitalization of the shares, or performance of the share market after listing. The focus should therefore be on ensuring that any return guarantee by a controlling shareholder to a pre-IPO investor, if to survive after listing, remains independent of specific market-related factors to uphold fairness and regulatory compliance within the Pre-IPO Investment Guidance.

Conclusion

Given the various restrictions in place, structuring a pre-IPO return guarantee must adhere to permitted arrangements to ensure its viability during the listing process. Due to the serious repercussions

of non-compliance, it is essential to approach these arrangements with caution. Care should be taken to avoid any correlation with the stock price or market value of the listed company. ■



Appendix 1

Abstract from the Pre-IPO Investments Guidance, Chapter 4.2 of the New Listing Applicant's Guide of HKEX (May 2024)

	Must terminate upon listing	May survive listing
Price adjustments	Terms which adjust the purchase price based on a discount to the IPO price or market capitalization must terminate upon listing regardless of whether they are settled by the applicant or a shareholder.	Terms that provide a fixed rate of return to the pre-IPO investor (which effectively reduces the price per share) and settled by a shareholder may survive after listing, provided that they are not based on a discount to the IPO price or market capitalization at IPO.
Financial compensation	Any financial compensation settled by the applicant or linked to the market price or market capitalization of the shares must terminate upon listing.	Any financial compensation settled by a shareholder and not linked to the market price or market capitalization of the shares may survive listing.
Divestment Rights	<p>(i) Unless provided in (ii) below, Divestment Rights must terminate before the First Filing. If an applicant fails to comply with the above requirement in respect of the termination of its Divestment Rights, the applicant shall be subject to the 120 Day Delay from the date of exercise or termination of any Divestment Right existing on the date of First Filing¹.</p> <p>(ii) Divestment Rights may exist on or after the First Filing if it is only exercisable when the listing does not take place² and will terminate upon listing.</p>	

¹ Unwinding a pre-IPO investment is not a remedy.

² Non-exhaustive examples of when a listing does not take place include any occurrence of events which would render the applicant unable to comply with the listing requirements or withdrawal/rejection/return/lapse of a listing application.