

Why PE doesn't have to be a gamble

A decision by the Supreme People's Court on the value adjustment mechanism has left investors worried, but if their intentions reflect the spirit of the mechanism the courts will still uphold their investments

The valuation adjustment mechanism (VAM), also known through its Chinese name as a gambling agreement, used to attract attention from private equity (PE) investors. This was caused by unexpected decisions made by the first instance court and the appeal court declaring the invalidity of the VAM arrangement in *Haifu v Shiheng and Diya*, dubbed as the first gambling agreement case. On November 7 2012, the Supreme People's Court (SPC) delivered its final judgment on the case by reversing the decision of the appeal court and upholding the VAM arrangement between Haifu, the investor, and Diya, the original shareholder. Understanding the Supreme Court's opinion is key for PE investors.

Haifu made VAM arrangements with the invested company, Shiheng, and the original shareholder, Diya. Haifu invested Rmb20 million (\$3.2 million) into Shiheng and became the other shareholder of Shiheng, holding 3.85% of its equity interest. The VAM agreed upon by the parties was that if Shiheng's net profit in 2008 did not reach Rmb30 million, Shiheng would indemnify Haifu in an amount equaling Rmb20 million multiplied by (1- 2008 net profit divided by Rmb30 million) and Diya would undertake the liability of indemnity if Shiheng failed to fully indemnify Haifu. The Supreme Court held that the VAM arrangement between Haifu and Shiheng was invalid, while holding that the VAM arrangement between Haifu and Diya was valid (see figure 1).



The Supreme Court denied the validity of the party autonomy between Haifu and Shiheng

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Invested company is not the proper VAM obligor

When the invested company is the VAM obligor, there are usually two ways for investors to realise the VAM: transfer of interests like cash indemnity or repurchase by the company in exchange for an agreed price. The SPC has indicated that transfer of interests is not a valid approach because it threatens the benefits to the company and the creditors. Repurchase is also problematic for two reasons. Firstly, most of the invested companies are limited liability companies and except in certain circumstances like having dissenting shareholders, repurchase by the company has no legal basis. Secondly, even if the company is allowed to repurchase itself from its shareholders, the payment of the repurchase price will most likely be deemed as an interest transfer that harms the creditors' benefit and may be invalid. There may another alternative, like increasing the shareholding ratio. But this means the investors have to contribute further in accordance with the registered capital of the company, so it may not be an ideal option for the investors.

When an invested company is the VAM obligor, the

interest transfer from the company to the investors will harm the company and its creditors. Based on the Supreme Court's decision in the Haifu case, the judicial opinion is that the invested company is not an appropriate VAM obligor.

Party autonomy

Shiheng, as the invested company, knowingly accepted the consequences of the VAM when it made the commitment. However, the SPC still held the commitment invalid on the grounds that it would harm the interests of Shiheng and its creditors. In other words, the Supreme Court denied the validity of the party autonomy between Haifu and Shiheng.

It seems implausible for the Supreme Court to rule that the VAM harmed the interests of Shiheng, which was aware of the consequences and made the commitment. The only

logical explanation is the Supreme Court considered that the indemnity agreed between Haifu and Shiheng reduced the assets of Shiheng and weakened its solvency, which in turn jeopardised the creditors' interests. Therefore, even if it was Shiheng's true intention to indemnify Haifu and bear the consequence of reduction of assets, the judgment means the courts will still not protect party autonomy in order to safeguard the creditors.

The interest of creditors

Although the Supreme Court found that the VAM arrangement between Haifu and Shiheng harmed the interests of Shiheng, which in turn harmed the creditors, the Court did not mention the other shareholder, Diya, whose interests would also be harmed as a consequence of Shiheng's reduced assets and weakened solvency.

According to Article 20 of the Company Law, which represented the legal basis for the Court's finding, Diya should have been one of the victims of Haifu's abuse of its shareholder's rights. If so, then why did the Supreme Court ignore this issue?

Similarly, Diya accepted the consequence of the indemnity agreed between Haifu and Shiheng, while such party autonomy, unlike the commitment made by Shiheng, seems to be recognised and protected by the Supreme Court. The only difference between Shiheng's party autonomy and that of Diya's is the

Figure 1: The SPC Judgment

... Shiheng and Diya ... agreed in the capital increase agreement that if Shiheng's net profit in 2008 did not reach Rmb30 million, Shiheng shall indemnify Haifu in accordance with the agreed calculation method. Such arrangement would ensure that Haifu obtains relatively defined profit from its investment. Such profit is not based on Shiheng's business performance and therefore jeopardises the benefits of Shiheng and its creditors. The decision made by the first instance court and the appeal court invalidating such arrangement based on Article 20 of the PRC Company Law (中华人民共和国公司法) and Article 8 of the PRC Sino-foreign Equity Joint Venture Law (中华人民共和国中外合资经营企业法) is correct ...

...Diya's commitment to indemnify Haifu does not jeopardise the benefit of the invested company and its creditors. It is not in violation of prohibitive provisions of laws and regulations and is the true meaning of the parties; therefore the commitment shall be upheld ...

former harms the creditors' interests, while the latter only affects Diya itself. It can be concluded that the SPC accepts and protects the party autonomy between the investors and the original shareholders, provided that such party autonomy does not endanger the creditors' interests. The Supreme Court's decision to uphold the VAM arrangement between Haifu and Diya reaffirmed this point.

Liability for fault

The VAM arrangement between Haifu and Shiheng created contractual claims for Haifu. When the VAM was held invalid, in accordance with normal practice, the Supreme Court should have reviewed the legal consequences of the invalidation and allocated the liabilities between Haifu and Shiheng based on the fault of the parties pursuant to Article 58 of the PRC Contract Law (中华人民共和国合同法). The Law stipulates that the party at fault shall be ordered to compensate the other party for losses suffered. In cases where both parties are at fault, they shall be ordered to assume liability accordingly.

In practice, when a contract term is held invalid for violating relevant laws and regulations, judicial organs will usually find both parties are at fault. Apparently, when the VAM between Haifu and Shiheng could not be realised, Haifu suffered losses and Shiheng should have been ordered to be liable to some extent. Nevertheless, the Supreme Court did not issue any judicial opinions on this issue. Although the SPC's decision enables Haifu to be compensated by Diya, the intentional avoidance of judging Shiheng's liability indicates that it is reluctant to order the invested company to assume the liability for fault, even if there is fault.

Protecting investors and shareholders

The Supreme Court points out in its judgment that the VAM arrangement between Haifu and Diya did not harm the interests

of the company and the creditors, nor did it violate the prohibitive provisions of the relevant laws and regulations. The Supreme Court's conclusion on the validity of the VAM between Haifu and Diya made it very clear that the VAM arrangement between the investors and original shareholders was legitimate and would be protected in China.

Even so, there are doubts on the actual protection investors may obtain from the Supreme Court's decision in this case. In practice, many original shareholders are shell companies incorporated for shareholding purposes only, which means they have no assets and are not capable of indemnifying the investors. The Supreme Court was well aware of this situation when it made its decision, which is causing some investors to worry that the judgment may be worthless under these circumstances.

In reality, there is no need for alarm. For example, imagine yourself in the position of Haifu and assume Diya is a shell company without assets, Haifu can still realise the VAM by enforcing Diya's shareholdings in Shiheng. When Diya fails to perform its obligation in the judgment, Haifu can file for enforcement to the appropriate court and the court will sell Diya's shares in Shiheng, provided that Diya has no other assets. Haifu will either recover the indemnity from the price received by the court or increase its shareholding ratio in Shiheng after proper valuation of Diya's shares.

It is understandable that the purpose of realising a VAM is not for investors to take back their investments. Rather, the purpose is to adjust the value of the shares to make it fair for all parties. As long as the investors' objective is to readjust the value of the shares rather than take back the funds invested, there is no need to worry about the solvency of the original shareholders. After all, the investors will be able to get appropriate shares in the invested company to make sure the VAM and their investment is still there.

Although VAM arrangements have been used by investors and Chinese companies, there are no pertinent laws and regulations to regulate the practice. The Supreme Court's judgment on in this case represents the first instance of the validity of the VAM being examined by the highest judicial organ in China. In other words, the Supreme Court's conclusion on this issue is mostly based on its subjective inclination rather than the result of established legislative guidance or sophisticated experience. This makes it more important for investors to look deeply into the points conveyed by the Supreme Court when structuring VAMs in China, as these points will be the guidelines for courts nationwide in deciding future VAM related disputes.

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- Is VAM still a safe option to protect investments, July/August 2012

RELATED LEGISLATION:

- PRC Company Law (中华人民共和国公司法)
- PRC Sino-foreign Equity Joint Venture Law (中华人民共和国中外合资经营企业法)
- PRC Contract Law (中华人民共和国合同法)

