Proceedings of the 3rd International Conference on International Law and Legal Policy
DOI: 10.54254/2753-7048/57/20240074

Performability of Valuation Adjustment Mechanism: Value Judgements at the Normative Level

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Abstract: On the occasion of a valuation adjustment mechanism, the main conflict of profit occurs between the shareholders of the repurchasable shares and the creditors of the target company. Since the introduction of the Minutes of the national courts' civil and commercial trial work conference (Minutes), the academic debate on the valuation adjustment mechanism has centred on the enforceability of the share repurchase clause therein. If the dispute is dealt with according to the literal meaning of Article 5(2) of the Minutes, it is not only detrimental to the maintenance of transaction security, but also systematically in conflict with Article 579 of the Civil Code of the People's Republic of China (hereinafter referred to as 'Civil Code') systematically. Therefore, by means of systemic interpretation, Article 5(2) of the Minutes can be limited to the case of 'insufficient distributable profits' in order to achieve the harmonisation of the normative system.

Keywords: valuation adjustment mechanism, share repurchase agreement, inability of performance, capital maintenance principle, pecuniary compensation

1. Introduction

Share repurchase agreement often occur in the context of venture capital, in which the company and the investor agree that the investor will invest in the company by purchasing shares of the company, and that if the company successfully completes its goals, such as an Initial Public Offering (IPO), the investor will continue to be a shareholder of the company, that if the company fails to successfully complete its goals, the investor may require the company to repurchase its shares or to compensate it in monetary terms.

The risk to the investor in a repurchase agreement is small compared to a normal capital transaction, and the reward to the investor in a repurchase agreement is large compared to a debt transaction [1]. However, assuming that there is no such favourable arrangement for the investor, the investor would not have chosen to inject capital into the target company, so there is a rationale for this type of transaction arrangement, which is formed under the autonomy of the parties. What needs to be considered is whether the company was forced to accept the valuation adjustment mechanism due to its unfavourable position, and the impact of the negative externalities of the valuation adjustment mechanism on the company's creditors and minority shareholders.

After the judgement of the Huagong case and the promulgation of the Minutes of the national courts' civil and commercial trial work conference (hereinafter referred to as the 'Minutes), the focus of the discussion has shifted from the validity of the valuation adjustment mechanism to the performance of the valuation adjustment mechanism, and Article 5 of the Minutes to the valuation adjustment mechanism has become the centre of the discussion day by day [2-3]. The relationship between the parties with conflict of interest in the dispute over the valuation adjustment mechanism can be analysed from three perspectives:

(i) Repurchasable shareholders and creditors of the company

The company is liable to the creditors with all its property, and the shareholders bear limited liability to the creditors to the extent of their capital contribution. The repurchase of the company's shares means the return of capital to the shareholders/investors, which will inevitably reduce the company's property and solvency, so there is a conflict of interest between the creditors and the investors in the context of the valuation adjustment mechanism [4].

(ii) Repurchasable shareholders and the company

The company is the subject of the valuation adjustment mechanism and should be contractually bound to fulfil the repurchase obligation to the shareholders. However, the company's fulfillment of the repurchase obligation means the return of capital contributions to the shareholders, which is likely to be accompanied by the effect of the company's capital reduction, which requires a majority vote of the company's internal capital. The internal will of the company is thus bound by external contractual obligations.

(iii) Repurchasable shareholders and other shareholders of the company

Unless specifically provided for in the articles, the distribution of profits of a company is governed by the principle of ‘equal rights for equal shares’, but ‘monetary compensation clauses’ in share repurchase agreements in fact allow some shareholders to be placed in a position similar to that of a creditor to receive an additional distribution of profits [5].

Whether to support or reject the investor's right of repurchase request means to answer the above conflict of interest. Many scholars have put forward legislative proposals based on comparative law paradigms or preconceived value positions. This paper argues that compared to calling for legislation, it is a more urgent task to clarify the value choices of the existing normative system in these issues through the means of legal interpretation. Therefore, this paper integrates the normative system of the Civil Code of the People’s Republic of China (hereinafter referred to as ‘Civil Code’) and the Company Law of the People's Republic of China (hereinafter referred to as the Company Law) to sort out Article 5 of the Minutes. Article 5 of the Minutes recognises the validity of valuation adjustment mechanism, but appears to impose a consequential limitation on its performability by requiring companies to go through a capital reduction procedure to repurchase their shareholdings. In practice, companies often fail to go through the capital reduction procedure, leaving the repurchase obligation in a state of non-performance. Therefore, it is necessary to sort out Article 5 of the Minutes in order to clarify its value judgement and conditions of use.

2. Weighing interests: value positions implicit in norms

2.1. Repurchasable shareholders and the company

The fact that the Minutes considers the valuation adjustment mechanism to be valid implies that the parties to this contract do not, in principle, have defective meanings. This indicates that, in the view of the designers of the norms, the valuation adjustment mechanism is not something that the company is forced to accept because it is in an unfavourable position; the company and the investor are equal subjects of private law in the agreement, and the company should be bound by its own promises.

2.2. Repurchasable shareholders and other shareholders of the company

Article 5, paragraph 3, of the Minutes allows investors to claim monetary compensation under the contract to the extent of distributable profits, which represents a partial break with the principle of ‘equal shares, equal rights’. In other words, in weighing the interests of the investor and the other shareholders of the company, the designers of the norms considered that the investor's right to pecuniary compensation should be given priority protection to the extent of the distributable profits, whereas other shareholders of the company should be favored beyond that extent.

2.3. Repurchasable shareholders and creditors of the company

In the valuation adjustment mechanism, the repurchase obligation of the company is essentially a pecuniary obligation, and according to Article 579 of the Civil Code, there is no impossibility of performance of pecuniary obligations [6]. However, the Minutes rejects the possibility of the investor requesting the court to compel the counterparty to perform the pecuniary obligation on the basis of ‘failure to go through the procedure of capital reduction’, so there seems to be a conflict in the normative system here. (The term ‘inability to perform’ in this context means ‘inability to compel performance’, which is distinguished from ‘active performance’. The Minutes takes the capital reduction procedure as a prerequisite for the fulfillment of the share repurchase obligation, which means that if the company does not take the initiative to complete the capital reduction procedure, the court will not support the investor's right of compulsory performance, which essentially constitutes the inability of performance.)

To maintain the unity of the legal system, it must be recognised that there is no inability to perform of a valid monetary obligation. It needs to be explained why the Minutes also stresses that the court should reject the investor's ‘actual performance claim’ under certain conditions. The norms of Article 5(3) of the Minutes seem to provide a reasonable path of interpretation. It is worth noting that the norms of this paragraph do not conflict with Article 579 of the Civil Code, because the debt of monetary compensation can be fulfilled within the scope of distributable profits, and when it exceeds this scope, it seems to be ‘unable to fulfil’, but in fact, this ‘unable to fulfil’ is a ‘partial inability’, while the entire monetary compensation obligation is in a state of ‘temporary inability’ (‘when the target company has profits in the future, the investor may also bring a lawsuit based on this fact’) [7]. In other words, the entire pecuniary obligation was in fact in a state of delayed fulfillment, not inability to perform, and therefore no conflict with Article 579 of the Civil Code.

The design of paragraph 3 provides a path for the interpretation of paragraph 2. The harmonious coexistence of ‘pecuniary obligations’ and ‘inability to perform’ requires a restrictive interpretation of ‘inability to perform’ as ‘temporary inability’ or ‘partial inability’. This means that the norm of paragraph 2 is in fact an illustration of the exception to the norm of paragraph 1: the norm of paragraph 1 assumes that the valuation adjustment mechanism is valid and that the monetary obligations therein should in principle be honoured. Paragraph 2 provides that, outside a certain ‘scope’, the monetary obligation must be subject to a capital reduction procedure in order to be honoured (and is in fact usually rendered unenforceable). However, as long as the company has sufficient money within a certain ‘range’, it should continue to honour the obligation. Overall, the repurchase obligation appears to be only temporarily incapacitated, i.e. delayed.

This interpretation also shows the result of the Minutes' discretionary approach to the interests of the parties. Within a certain ‘range’, the designers of the norm considered that the interests of investors should be protected in preference to those of other stakeholders, such as creditors, but beyond that ‘range’, the protection of other stakeholders is favoured. The task of the interpreter is to clarify this ‘range’ implied in the norm.

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3. Determination of standards: intentional repurchases under financial constraints

3.1. Distributable profit as standard

Paragraph 3 of Article 5 of the Minutes requires the judge to conduct an examination on the basis of ‘shareholders shall not abscond from the capital’ and the mandatory provision on profit distribution, and through this examination, the judge derives the boundary of the fulfilment of the obligation of pecuniary compensation by means of ‘distributable profits’. The inverse of this process of derivation shows that the Minutes uses ‘distributable profits’ as a boundary to delineate between lawful profit distribution and evasion of capital contribution. If the threshold of ‘distributable profit’ is not exceeded, the target company's fulfilment of its monetary compensation obligation to the investors can be regarded as a lawful distribution of profit to the shareholders. However, if the threshold of ‘distributable profit’ is exceeded, the target company is considered to have actually returned the capital contribution to the investors, and should be prohibited under the rule of capital evasion.

This norm requires the judge to examine the case on the basis of ‘shareholders are not permitted to withdraw their capital’ or the mandatory provision on share repurchase. By interpreting paragraph 3 above, it can deduce the relationship between these two provisions, i.e., within the scope of ‘distributable profits’, the target company's repurchase of investors' shares is legal, while beyond the scope of ‘distributable profits’, the act constitutes a return of capital to shareholders. Beyond the limit of ‘distributable profits’, the act constitutes a return of capital to the shareholders, which should be prohibited if the procedure of capital reduction has not been fulfilled. From the above explanation, it can be concluded that the ‘limitation of scope’ implied in this paragraph is the ‘distributable profit’.

3.2. Distributable profits and the capital reduction procedure

It has been incorrectly argued that the successful execution of a capital reduction procedure by a company is a prerequisite for the fulfillment of its share repurchase obligation, so what remains to be clarified is the relationship between the target company's fulfillment of the share repurchase obligation within the scope of ‘distributable profits’ and the capital reduction procedure, and how the judge should apply the share repurchase norms to the review of the investor's request within the scope of distributable profits [8]. In fact, an interpretation of Article 142 of the Company Law shows that share repurchases and capital reduction procedures are inherently independent of each other, because even under the statutory repurchase rules, carrying out a capital reduction is only one of the purposes of a share repurchase [9]. The purpose of the Minutes in forcing the capital reduction procedure to be tied to the fulfillment of the share repurchase obligation outside the scope of ‘distributable profits’ is to strengthen the protection of creditors through the capital reduction procedure. However, within the scope of ‘distributable profits’, the amount of share capital relied upon by creditors will not be impaired by the target company's fulfillment of its repurchase obligation [10]. Therefore, the Minutes, by virtue of Article 142 of the Company Law, clarify that within the scope of ‘distributable profits’, the share repurchase and capital reduction procedures are no longer forcibly tied to each other, and that the two are returned to the independent relationship established by Article 142 of the Company Law. When the target company has profits, it cannot use the ‘failure to go through the capital reduction procedure’ as a defence against the investors' repurchase request. After repurchasing the shares, the target company can of course absorb the shares by means other than capital reduction (e.g. by implementing an employee shareholding plan) [11], but if the company wishes to cancel the shares, it still needs to go through the capital reduction procedure, which is also conducive to the creditors' monitoring of the target company's financial situation, so as to prevent the company from returning its capital contribution to the investor outside the scope of the distributable profit [11].

4. Discussion: the capital maintenance principle in the normative system of the Company Law

The Chinese Company Law does not explicitly provide for the capital maintenance principle, but as one of the three major principles of company law, it still unites the consensus of today's academic community [12]. It is generally believed that the capital maintenance principle covers both the capital inflow and capital outflow systems. After the adoption of the subscribed capital system in the Company Law, the restriction of the capital inflow system has been eased, but the share repurchase system and the profit distribution system, which regulate the outflow of capital, still strictly abide by the bottom line of capital maintenance [13]. For example, in the system of capital evasion by shareholders, the boundary between ‘profit + surplus reserve’ and ‘share capital + capital reserve’ is the boundary between ‘illegal distribution’ and ‘capital evasion’ [14]. Under the profit distribution system, a company is required to distribute profits to its shareholders within the limits of its ‘profit after tax for the year’. In Article 5(3) of the Minutes, regarding the obligation of monetary compensation in the valuation adjustment mechanism, the designer of the regulation uses ‘profit’ to delineate the boundary of fulfillment. In paragraph 2, on the obligation to repurchase shares, it is only when the scope of ‘distributable profits’ is exceeded that the Minutes uses the capital reduction procedure as a prerequisite for the target company to fulfil its repurchase obligation. Together, these norms point to the principle of capital maintenance, which is an important part of the internal system of the Companies Law.

At the boundary between profit and equity, the value choice of the norms of Article 5(2) of the Minutes is transformed. Within the scope of distributable profits, the designer of the norm, taking into account the unique nature of pecuniary debt, clarifies the position of giving priority to the protection of investors' interests by recognising the validity of valuation adjustment mechanism. Behind this position is a value judgement that encourages investment and affirms the autonomy of private law. When the scope of distributable profits is exceeded, the norms change their stance and impose strict protection on creditors, maintaining the status of ‘equal shares and equal rights’ among different shareholders. Behind this position are the principles of capital maintenance and transactional trust. When principles are in conflict, the designers of the code do not adopt an ‘all or nothing’ attitude, but shift their position according to the criterion of financial constraints.

5. Conclusion

There are multiple sets of conflicting profits of related subjects in the valuation adjustment mechanism, but the conflict of profit between the company's creditors and the shareholders of the repurchasable shares plays the biggest role in the legal value judgment. In the event that the company fails to accomplish the goals agreed upon in the agreement, the shareholders of the repurchasable shares may invoke Article 579 of the Civil Code as the basis of their claim and Article 5 of the Minutes as the norm for the happening of rights. However, when the target company's distributable profits are insufficient to pay for the share repurchase, it can invoke the norms of Article 5, paragraph 2 of the Minutes to defend the shareholders, putting the share repurchase obligation in a situation of partial failure to perform (and overall in a situation of delayed performance). If the target company subsequently has sufficient distributable profits, the defense disappears and the repurchase obligation is still enforceable. This paper is still deficient at the level of empirical research and needs to be followed up with further research.

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