

Research on the Valuation Adjustment Mechanism in Private Equity Financing

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Abstract: As new economy arises, private equity financing has been further developed because of limited financing channels. However, with the application of the VAM (valuation adjustment mechanism) arising from private equity financing in China, the dispute over the legal effect of the VAM has yet to be settled.

1. Introduction

With the continuous development of the economy, the new economy has gradually become an important part of the current economy. New economy companies with high human capital investment, high-tech investment and light assets begin to take the upper hand in the market and system (such as the liberalization of Hong Kong's dual-class shareholding structure), meanwhile, those companies are inevitably caught in financing plight. Banks, the backbone of the financial system, should obey the principle of prudence in assets operation because of the public nature of their business (i.e. the characteristic of taking deposits from non-specific people as the source of funds for re-lending) and charge necessary interest on borrowings to get predictable returns. As enterprises with light assets, the new economic companies have both chances and risk in their development, which makes them not the preferred object of banks that regard capital security as a criterion.

At the same time, investors have the need for financial management-the economic development during the 40 years of reform and opening up has brought about an increase in living standard and in the amount of idle funds in the society. On the one hand, many companies are badly in need of funds to develop. On the other hand, investors who have the funds are eager to seek investment opportunities. So the vigorous development of "private equity investment" makes sense.

It is difficult to forecast the profit of the new economy companies due to the lack of reference, the rise and fall of the Internet economy and other industries which are closely related to national policies. According to the "risk aversion" and "risk compensation" theory, the rational investors need to get high returns with certain guarantees in case of high-risk investment. All that make the VAM came into being. After its advent, VAM was not only seen frequently in the financial industry, but also caused a long-term dispute over its legal effects in the field of civil and commercial law.

2. Brief Description of Private Equity and Vam

2.1 Brief Description of Private Equity

2.1.1 Definition of Private Equity

Private Equity (PE) refers to an investment in unlisted equity or non-publicly traded shares of listed companies. From the perspective of investment methods, private equity refers to the equity investment in private enterprises, i.e. non-listed enterprises through private placement. In the process of transaction implementation, the future exit mechanism is considered, i.e. sell shares to make a profit through listing, merger or management buy-outs. [1]

2.2 Characteristics of Private Equity [2]

2.2.1 Non-Publicly Recruitment

Private equity investment is raised in a non-public way. The Securities Investment Fund Law of the People's Republic of China and the Interim Measures clarify the rules for non-public fundraising of private equity funds, it shall not raise funds from units and individuals other than qualified investors and shall not promote to any non-specific objects through the public media such as newspapers, radio, television stations, and the Internet or lectures, presentations, analysis sessions and announcements, flyers, text messages, WeChat, blogs, and emails .

2.2.2 Company Equity-Oriented Investment

Private equity mostly involves in equity investment and rarely adopts debt investment. Therefore, in term of investment instruments, private equity often adopts common stock, transferable preferred stock, and convertible bonds.

2.2.3 Prior Agreement on the Exit Mechanism

Based on the nature of investment, in general, private equity investment will make prior agreement on the exit mechanism, including public listing, reverse mergers and acquisitions, equity transfer, liquidation and bankruptcy, and asset restructuring.

2.3 Brief Description of the Vam

2.3.1 Definition of Vam

Valuation adjustment mechanism (VAM) is widely used in the international capital market between enterprises and investors. It is common in M&A transactions, and the main purpose is to balance the differences in the value of the acquisition due to the gap between the expectations of the company's future growth of investors and the investee. The content of the VAM varies from project to project. For example, the indicator can be the sales income, profit or the growth rate of net profit and etc. And the result of the VAM can be equity change, asset restructuring or cash payment and etc.

2.3.2 The Effect of the Vam

In China, VAM can be also known as gambling agreement. The “gambling” title of the agreement has actually hidden the external negative evaluation. Indeed, cases of disagreement or even resort to courts are everywhere because they ultimately fail to meet the expectations of investors.

On the one hand, if the VAM is properly designed, it will have the effect of stimulating financing, which will bring benefits to both sides—the financing party can obtain funds and additional rewards by exceeding the expected growth; the investing party can champion their rights to a certain extent through contractual agreements to offset the disadvantages caused by information asymmetry in business investigations before investment. It is a win-win situation.

On the other hand, there is no prohibition on the VAM in the Chinese legal system, but some of the provisions in the VAM are contrary to the laws and regulations in the Company Law . From the perspective of the public's unreasonable justice views, it is easy to disagree with the rationalisation and legitimacy of the VAM because of the sympathy for the weaker side. All that make the legal effect of the VAM questioned. Trial results of similar cases may be poles apart.

Therefore, it is practical to explore the legal effect of the private equity gambling agreement.

3. The Analysis of the Legal Nature of Vam

3.1 The Vam Does Not Belong to the Aleatory Contract

The aleatory contract was involved in the ancient Roman law. At that time, the understanding of the contract was that the contracting parties did not buy or sell the specific things, but merchandise

unproduced things. In statute countries, the Civil Code in French first adopted the concept of a aleatory contract, and defined it as a contract in which benefit of contract subject or the adverse consequences will be changed after the determination because uncertain things become certain. [3]

In term of characteristics, the aleatory contract has the following features: after the signing of the agreement, it has legal effect and is binding on both parties. No party may request the cancellation or termination of the contract due to the absence or loss of the subject matter of the transaction; The legally binding effect of the agreement is unknown at the time of signing the contract; the payment obligation determined by the aleatory contract is determined from the beginning, but the implement to pay is uncertain according to the occurrence of a certain fact. And there are often differences between the benefit of the two parties .It is because the aleatory contract is the trigger cause with uncertainty which make it easy to cause the moral hazard between the parties. Therefore, the aleatory contract has strict legality, making almost all countries that recognize the effectiveness of the contract have strict regulations on.

Therefore, domestic scholars including Shi Haishan, Fu Wei, Xie Haixia and others believe that the legal nature of the VAM is the aleatory contract. However, the author remains neutral about that through learning and reading materials. The reasons are as follows. First, the core feature of the aleatory contract is that either party may be profitable or lose money. The parties to the contract have imbalances in income and expenditure, and one party's contribution corresponds to the other party's losses, which means there is no win-win outcome. However, in the case of the VAM, as mentioned above, if the company goes public, it is actually a win-win outcome for both parties - the investor can obtain the investment income (and the income is generally greater than the incentive expenditure for the target company),and the target company can also receive additional revenue. Second, both parties have “risk preference” in the aleatory contract, such as lottery, gambling, etc., people often overlooking high risks due to high returns. In the agreement on gambling, which seems to ignore high risks because of high returns. However, in VAM, the two parties still conclude an investment agreement under private equity, and the investor has a rational attitude toward the investment. That's why the investment agreement has complicated compensation clauses and gambling clauses to protect the interests of investors, which is also different from the aleatory contract. In addition, the trigger cause in the aleatory contract is accidental, and subjective initiative also contributes a lot to final result of the VAM.

3.2 The Vam Does Not Belong to the Conditional Contract

Article 45 of the Contract Law expressly stipulates that the conditional contracts can be listed as named contracts. A conditional contract is a contract in which both parties have made an agreement in advance, and determined whether the contract would be performed or not based on whether the condition was generated or not.

Most of the VAM are accompanied by gambling content and compensatory clauses, with the expression “if the above situation cannot be achieved “, which meet the regulations of conditional contracts. However, for conditional contracts, the contract does not take effect until the conditions are generated. In other words, the effective date of the contract depends on the generation of the condition. As for the VAM, the contract will take effect immediately after its conclusion, and the content agreed upon in the VAM must be fulfilled regardless of whether the target is fulfilled or not. After the expiration of the time limit agreed upon in the VAM, it is legally binding on both the investor and the investee to protect the legitimate interests of the parties involved in it, which means whether the target is achieved or not doesn't matter. Indeed, in the VAM, the condition is that one party have certain rights, such as requiring repurchase of shares, cash compensation, and so on. However, in terms of effective time, the VAM has taken into effect at the time of its signing, and the parties have begun to implement specific treaty based on it. From this point of view, there is significant difference between the VAM and conditional contract.

In addition, in terms of the purposes of the contracts, the conditional contract is mainly to clarify the rights and obligations of the two parties. According to the item description, the VAM is to reconfirm the interests and rights of both parties so as to balance the allocation of risks arising from

information asymmetry of pre-investment after the company performance of the investee is determined.

3.3 The Vam Belongs to Unnamed Contract

An unnamed contract refers to a contract that is not included in the fifteen kinds of contracts specified in the Contract Law of China, that is, electricity supply, water, steam, heat contracts, gift contracts, loan contracts, lease contracts, financial lease contracts, contract contracts, , construction contract, transportation contract, technical contract, custody contract, warehousing contract, entrustment contract, line contract, and other contracts other than the intermediation contract, the author believe that the VAM is an unnamed contract.

The VAM is an unnamed contract signed between the fund supplier and the demander for equity investment, which stipulates the rights and obligations of both parties, including specific content, and the responsibilities of both parties if the demander fails to achieve the performance or listing target. Under the premise that the meanings of both parties are consistent and the subject is appropriate, the explicit rights and obligations are in line with the requirements of the unnamed contract. Article 124 of China's "Contract Law" clearly stipulates the law that can be applied to the unnamed contract. If the conclusion is made that the VAM is an unnamed contract in the legal nature, the judicial community should comprehensively refer to the content of the contract, the General Principles of Civil Law and the principles of the Contract Law, the Company Law, and the Securities Law to examine this unnamed contract.

With the development of economy and society, the VAM emerge in endlessly, which indicates the problem that investors still have insufficient information about the target company and the mistrust of the profitability of it is difficult to solve. To some extent, the VAM is a protection of the investment company. If it is prohibited roughly, it may be adverse to the development of the new economy. Therefore, the regulation of effectiveness on the basis of certainty will help solve the problem.

4. Analysis of the Legal Effect of the Vam

When it comes to the legal effect of the VAM, it is said that VAM between the investor (ie the fund provider) and the financing party (ie the capital demander, the target company's old shareholders, the original shareholders) can be legally examined with the reference to the existing legal provisions. If the results are legal and valid, there is little argument between the theoretical circle and judicial practice. However, some of the VAM between the investor (i.e. the fund provider) and the financing target company promise the legal effect which may bring about great divergence.

In terms of the eligibility of the subject, the real intention and the clarity of rights and obligations, it is not difficult for the VAM to come into force as a contract. In fact, it is often invalid due to violation of laws and regulations, which is true in practice. For example, the VAM indicates that the directors sent to the board should be given "one-vote veto" and the investor should be given "priority profit distribution right". The "Company Law" stipulates: "Shareholders attend the general meeting of shareholders, each shareholding means one vote."; "The voting of the resolution of the board of directors shall be one person, one vote."; "Every share of the same kind should have the same rights", the above clauses in the VAM may be invalid because they are contrary to the provisions of laws and regulations. For the companies to be listed, the "Implementation Measures for Initial Public Offering and Listing" issued by the CSRC(China Securities Regulatory Commission) requires that the shareholding structure of the enterprise should be stable and clear. The VAM involving equity may often result in significant equity changes after the listing. All that make pre-marketing VAM not allowed by the CSRC .

It must be acknowledged that the commercial law system represented by China's current company law is not conducive to the existence and development of the VAM. "Company Law" in China stipulates that shareholder-related benefits must be limited to capital contribution, and those shareholders must be responsible for the company and share the interests and risks with all investors. Although the VAM violates the principle of risk sharing on the surface, in fact, the shareholders

only want to obtain returns and investment income from equity investment instead of intending to participate in shareholder management to exercise other shareholders' rights.

In other words, in private equity investment, investment is the real intention of fund supplier compared with the stock equity. As China has no category stocks, the reason why the gambling agreement is invalid is not because of its internal theory. It meets the requirements of China's contract and assumes that higher risk will bring higher returns, which does not lead to the imbalance of interests. As for the "risk sharing" principle, it is also a "helpless move" under the current Chinese commercial law system. The investor itself does not have the thought of participating in the company's operation, sharing risks and benefits. In addition, limited information disclosure makes it difficult to know the panorama of the target company's operating conditions, leaving VAM a complement to the information asymmetry.

In a word, the ineffectiveness of the VAM stems from the conflict between its premised rights and obligations and China's mandatory regulations. However, even if the specific clauses conflict with existing laws and regulations, we should also review their legal effects according to the specific conditions of the VAM instead of negating the legal effect of it directly, which will not be conducive to the development of the private equity.

5. Conclusion

At present, due to the lack of provisions on category stocks and dual equity in mainland China, it seems inevitable that the VAM should be invalid on account of its conflict with mandatory regulations. This problem indicates that China's financial regulations are not compatible to the international financial market. Therefore, guiding cases, judicial interpretation and other means are good ways to solve the legal effect of the VAM. But what is more important is to make adjustments in corresponding policies. Otherwise, it can still be a temporary measure even if the issue of the effectiveness of the VAM is resolved.

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