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Supreme Court Upholds Validity of VAM Agreement between Shareholders: Implications and Considerations

By Leo Wang and Peiming Yang

The Supreme People's Court ("SPC") rendered its final judgment in the case involving the valuation adjustment mechanism ("VAM")[1] used by domestic private equity ("PE") firms. While denying the validity of the VAM agreement clauses between shareholder and company, the SPC, for the first time, recognized the validity of VAM agreements between shareholders. The article provides a brief introduction and analysis of this case and its risk indications.

Case profile

In October 2007, prior to Suzhou Industrial Park Haifu Investment Ltd's ("Haifu") investment, Gansu Shiheng Non-Ferrous Metal Recycling Ltd.[2] ("Shiheng") had a registered capital of USD3.84 million and was a wholly-owned subsidiary of Hong Kong's Wisdom Asia Limited ("Wisdom"). Haifu then signed a Gansu Zhongxing Zinc Industry Co., Ltd Capital Increase Agreement ("Capital Increase Agreement") with Shiheng, Wisdom and Lu Bo (Shiheng's legal representative and general manager, and also Wisdom's president). Pursuant to the agreement, Haifu would inject RMB20 million into Shisheng (RMB1,147,717 of which formed part of Shisheng's increased registered capital, and the remaining RMB18,852,283 went to Shisheng's capital reserve). After completion of the investment, Haifu would hold 3.85% of Shisheng's equity interest and the remainder would be held by Wisdom.

Under Article 7(b) ("VAM clause") of the Capital Increase Agreement, in respect of Shiheng's performance target, if by the end of 2008 Shiheng's net profits would be less than RMB30 million, Haifu should be entitled to obtain compensation from Shiheng; and if Shiheng failed to fulfill its obligation, to claim the same from Wisdom. The formula for calculating the preceding compensation payable was (1 – the actual net profits of 2008 / RMB30 million) × the invested amount (RMB20 million).

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The actual net profit of Shiheng in 2008 turned out to be only RMB26, 858.13. Under the VAM clause, Haifu required Shiheng to return RMB19,982,095 as compensation. A dispute thus arose between two parties, and Haifu filed a lawsuit against Shiheng, requesting Shiheng to fulfill its obligation under the Capital Increase Agreement.

Court decisions

In December 2010, the court of first instance, Lanzhou Intermediate People's Court, held that the VAM clause was invalid and turned down Haifu's claims. Dissatisfied, Haifu lodged an appeal. In September 2011, the Gansu Higher People's Court issued a second instance ruling that held the VAM clause invalid, but unlike the court of first instance, the appeal court considered that out of Haifu's RMB20 million investment (except RMB1,147,717 invested in the registered capital of Shiheng), RMB18,852,283 was "an investment in name, a de facto loan" and ordered Shiheng to return it plus interest. Shiheng disagreed with the ruling and filed a demand for a retrial with the SPC and a motion to withdraw the judgment of the appeal court and uphold that of first instance court.

In December 2011, the SPC accepted Shiheng's request for retrial[3] and arranged a retrial. In November 2012, the SPC made a final decision withdrawing the judgment of the appeal court and requesting Wisdom to pay RMB19, 982,095 in compensation, as specified in the agreement with Haifu.

The SPC found that the VAM clause effectively granted a fixed profit for Haifu's investment and such profit is out of the actual business performance of Shiheng, thus it impaired the interest of Shiheng and its creditors, hence, the lower courts were correct in invalidating the VAM clause based on provisions of Article 20[4] of the Company Law and Article 8[5] of the Sino-Foreign Equity Joint Venture Law. Further, the SPC overruled Gansu Higher People's Court's decision in second instance, disagreeing with the ruling that Shiheng and Wisdom should indemnify Haifu its investment totaling RMB18,852,283 as "an investment in name, a de facto loan", on the basis that such ruling lacks legality support.

The SPC also confirmed that, Wisdom's commitment (as a shareholder) to compensate Haifu (as PE investor) was the parties' true intention. This agreement neither injured the interest of the company or its creditors, nor violated the mandatory provisions of laws or regulations, thus it was valid.

Significance of this case

The VAM agreement is commonly used in PE investments in China[6], and its validity has long been a contentious issue[7] as there is no authoritative judicial interpretation or precedent to identify the validity of the VAM agreement governed by the PRC laws.

The SPC's judgment not only upholds the principle of protecting the interests of a company and its creditors, but also takes into account the positive role of adjusting valuation and encouraging investment that the VAM agreement plays in the PE practice. Undoubtedly, it is beneficial to the development of China's direct investment market and helps the financing activities of startups. The SPC's ruling that denies the validity of the VAM agreement concluded with the target company and affirms the validity of such an agreement signed with shareholders of the target company is bound to have a significant impact on the risk locking mechanism of the PE investment, and could become a landmark case in this field.

Further considerations and risks

This is the first case where the SPC has upheld the validity of the VAM agreement between shareholders. There is no doubt that it will attract intense attention in PE investment and law practice, and practitioners should further consider that, in this case, if Shiheng had a negative or zero net income in 2008, it may be uncertain if the compensation payment as set forth in the VAM agreement should be determined according to the formula for calculating such compensation as agreed in the VAM agreement. If Shiheng had a deficit in 2008, the amount of Haifu's compensation would exceed its original investment under the VAM agreement. Wheras Haifu's stock equity in Shiheng would be valued far above zero even if Shiheng sustains loss (under the legal principle of shareholder's limited liability in a limited corporation, when a company goes bankrupt the equity stake held by shareholders is valued zero), the overpaid compensation under the VAM agreement will not justify the purpose of estimated value-based compensation.

The contract law has a "principle of compensation for losses" concerning claiming for damages for a breach of contract, and such compensation should be in line with the doctrines of fairness and legality. If the VAM agreement completely disregards the original intention and purpose of valuation adjustment, and simply bets on the condition of the predicted future net profits, it might be defined as illegal gambling[8]. As the VAM agreement is essentially a valuation adjustment convention, we believe that the valuation compensation paid as agreed under the VAM agreement will be required to comply with the principle of compensation for losses and the doctrine of fairness in certain circumstances, that is, shareholders concluding the VAM agreement shall implement the valuation adjustment of the VAM agreement and make compensation aiming solely at making up the predictable valuation losses of the target company when the agreement is signed, as well as under the fairness doctrine. For instance, where the expected valuation of a target company when shareholders enter into a VAM agreement is not lower than the minimum amount "N" recognized by a PE, then even if the target company gets a negative or 0 performance during the period of the VAM agreement, the compensation paid under the VAM clause shall not be higher than the[1-(N/expected performance)]×investment amount.

Base on the above principle of compensation for losses and the fairness doctrine, it should be noted that even though that the SPC has upheld the validity of the VAM agreement between shareholders in this case, there are still risks in similar lawsuits where the proportion of compensation that goes beyond the reasonable limit would not likely be upheld by courts. Therefore, not only the target company that PE invests in, and such company's actual controller should carefully consider a reasonable valuation of the target company, but also PE investors need to seriously look at the acceptable minimum valuation of the target company and relevant compensation range when using a VAM agreement to maintain the investment value.

1. Valuation Adjustment Mechanism (VAM or gambling agreement), is a commonly used agreement between investors and the financing side on further changes when they conclude a financing agreement. If certain agreed conditions are met, the investors are entitled to exercise certain rights; otherwise, the financing side may exercise certain rights.
2. At that time, Gansu Shiheng Non-Ferrous Metal Recycling Ltd was known Gansu Zhongxing Zinc Industry Co., Ltd.

3. Retrial is a recurrence of a court case based on the procedure for trial supervision. Under Article 177 of the PRC Civil Procedure Law (2007), If the Supreme People's Court finds some definite errors in a legally effective judgment or rulings rendered by a local people's court at any level, or if a people's court at a higher level finds some definite errors in a legally effective judgment or ruling of a people's court at a lower level, the Supreme People's Court or the people's court at the higher level shall have the power to bring the case up to be re-adjudicated by itself or direct the people's court at a lower level to conduct a retrial.
4. Article 20 of the Company Law stipulates that, the shareholder of a company shall observe laws, administrative regulations and the company's articles of association, exercise the rights of a shareholder according to law, and may not abuse his rights to impair the interests of the company or other shareholders; and he may not abuse the independent status of the company as a legal person or the limited liability of shareholders to damage the interests of the creditors of the company. Where the shareholder of a company abuses the rights of shareholders and thus causes losses to the company or other shareholders, he shall be liable for all damage according to law.
5. Article 8 of the Sino-Foreign Equity Joint Venture Law provides that, after payment of equity joint venture income tax on an enterprise's gross profit pursuant to the tax laws of the People's Republic of China, after deductions there from as stipulated in its articles of association regarding reserve funds, employee bonus and welfare funds and enterprise development funds, the net profit of an equity joint venture shall be distributed between the equity joint venture partners in proportion to their investment contribution to the enterprise's registered capital.
6. The VAM agreement is commonly used in the PE investments in China. In general, the investors and financing parties determine the investment conditions on the basis of the current performance of the invested company, according to the growth in earnings that is agreed by the parties, and the agreement is conditional on the specific performance target, if the agreed conditions are met, the investors may exercise the valuation adjustment right. The subject of VAM agreement is usually the company's stake or direct payment of cash and interest.
7. For instance, a judge of the Shanghai Higher People's Court, Zhang Fengxiang believes that, from the perspective of the contract law, a VAM agreement controls risks in essence, and constrains rights and duties of the parties, it neither conceals illegal intentions beneath an appearance of legality, nor violates mandatory regulations and jeopardize public interests, so it is not inconsistent with the existing contract law. From the perspective of the finance law, the VAM agreement is not in the common sense understanding of the joint operation, as the investors under the VAM agreement participate in the operation and management of a company as shareholders; besides, the agreement is a way of controlling and preventing operational risks, not a loan in concept.
8. Unless otherwise permitted by laws and administrative regulations, gambling for profit in China shall be deemed to be an unlawful act violating the laws and administrative regulations such as the Criminal Law and the PRC Regulations on Administrative Penalties for Public Security.

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