The Impact of Target Company Liquidation on Investors' Withdrawal

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In recent years, numerous enterprises are poorly managed, leading to the liquidation causes agreed under the investment agreement signed by the investor and the target company triggered or triggered simultaneously with the buyback scenarios. However, when the investor actually requires liquidation or buyback, it faces many obstacles. This article combines the current judicial practice to analyze the relevant risks of investor withdrawal for reference.

1. If there is no special agreement, the liquidation of the target company does not necessarily lead to the loss of the investor's buyback right

If the liquidation causes occur and the investor exercises the buyback right simultaneously, the target company or the founding shareholders often argue that the company is dissolved and liquidated, and refuse to fulfill the buyback obligation. But in fact, the target company enters the liquidation process does not necessarily affect the investor's exercise of the buyback right.

In practice, the buyback obligor is usually divided into two categories: the target company and the founding shareholders.

- If the target company is agreed to buyback, according to the judicial rules established in the " The Ninth Conference Minutes", the investor has no right to demand buyback when the target company has not completed the capital reduction procedure. Therefore, it is difficult to require the target company to buyback itself in practice. If the company is dissolved and liquidated, it is more difficult to require the company to reduce capital. This article does not make too much analysis under this circumstance.

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- If the founding shareholders buyback is agreed, the liquidation of the target company usually does not affect the exercise of the buyback right by the investors. However, due to the special provisions on the liquidation of the company in the Company Law and the Bankruptcy Law, the investors still need to pay attention to avoid relevant risks when exercising their rights.

(1) The law does not prohibit the transfer of equity of the company in liquidation

The current law does not explicitly prohibit the transfer of equity of the company in the liquidation stage. The Article 186 of the Company Law revised in 2018 stipulates that during the liquidation period, the company exists, but it shall not carry out business activities unrelated to the liquidation (the provisions of the Company Law that will come into force on July 1, 2024 are retained).In practice, there are companies or founding shareholders who claim that the transfer of equity is unrelated to the liquidation, so the investors have no right to demand buyback. For this issue, in the case of (2020) Guangdong Minshen 11917, the court believes that "the manager's cooperation in assisting in the equity buyback is also a matter of settling and solving the related affairs of Ruijing Company, which should not be considered as activities unrelated to the liquidation, and the Bankruptcy Law does not prohibit shareholders from transferring the equity of the bankruptcy liquidation enterprise". In (2023) Guangdong 06 Minzhong 4350, the court also supported the party's demand for the buyback of the equity of the bankrupt enterprise. Therefore, the fact that the target company has entered the liquidation process is not a legitimate reason for refusing the buyback.

(2) The manager of the target company has no right to rescind the agreement between shareholders on equity repurchase

If the target company enters bankruptcy liquidation, according to the provisions of the Bankruptcy Law, the manager has the right to decide to rescind the contract established before the acceptance of the bankruptcy application and the debtor and the other party have not fulfilled the contract. But if the repurchase obligation between shareholders does not include the target company, the manager has no right to rescind the contract, and the investor can still require the founding shareholder to repurchase. The case of (2020) Guangdong Min Shen 11917 also confirmed this view.

(3) After the target company completes cancellation, the investor's re-request for repurchase is deemed as non-performance

After the repurchase conditions are triggered, if the investor fails to exercise the repurchase right in time and the target company is cancelled after liquidation, there is a risk of the loss of the repurchase object and the fact that the repurchase right cannot be performed. In the case of (2022) Zhejiang 04 Min Zhong 1193, the court considered that the target company had been cancelled, and the investor's repurchase request could not be objectively performed, and did not support the investor's appeal for repurchase. Therefore, the liquidation of the target company does not necessarily prevent the investor from exercising the repurchase right, but it is suggested that the investor exercise the right as soon as possible when the repurchase conditions are triggered, and complete the equity transfer as soon as possible, so as to avoid the fact that the repurchase right cannot be performed due to the cancellation of the target company.

2. Strictly check the expression of liquidation terms to avoid the loss of the investor's repurchase right

In a case we once handled, the buyback condition agreed in the investment agreement was "the fair value of the company is less than 200 million yuan". If this condition is triggered, the investor has the right to ask the founding shareholder to buy back. The liquidation clause agreed in the investment agreement is "in the event of any of the following events ("liquidation events"), unless otherwise agreed by the parties, this agreement shall terminate in advance and the company shall be liquidated and dissolved: a) the company suffers significant losses in any fiscal year due to reasons other than force majeure events. "Significant losses" refers to the total loss in the fiscal year reaching or exceeding 50% of the company's net assets in the previous fiscal year or 50% of the company's registered capital..." Due to the poor operation of the target company, serious losses for several years, insolvency, and the founding shareholders also give up managing the company, the buyback condition and liquidation events agreed in the investment agreement are triggered. Then the investor initiated arbitration to ask the founding shareholder to buy back the equity, and the founding shareholder believes that according to the liquidation clause, the investment agreement has been terminated, the company should be dissolved and liquidated, so there is no need to fulfill the buyback obligation. The case was finally settled, but the risks related to the investment agreement are obvious to the investor. It is suggested that when drafting the terms of the investment agreement, consider the following aspects:

(1) Clearly require liquidation as the right of the investor

In addition to the statutory liquidation causes, if the agreed liquidation event is added in the investment agreement, it is suggested that when the agreed liquidation event occurs, the investor "has the right" to require the company to liquidate, rather than the company "should" liquidate, the requirement of the company to liquidate is the right of the investor rather than the obligation to cooperate with the liquidation, so as to avoid the direct liquidation of the company once the liquidation event occurs, resulting in an uncontrollable situation.

(2) Pay attention to the compatibility of liquidation clauses and repurchase clauses

When the specific liquidation event is agreed in the investment agreement, such as the target company has a significant loss, unable to operate, etc., it is suggested to pay attention to whether the liquidation and repurchase conditions overlap, that is, whether the same event leads to the repurchase conditions and liquidation conditions are triggered simultaneously. If there is such a possibility, it is suggested that the repurchase and liquidation are agreed as the right of the investor, that is, the investor has the right to choose what right to exercise. At the same time, it is suggested to avoid the expression that the investment agreement will terminate if the liquidation event occurs, so as not to affect the exercise of the investor's repurchase right.

3. Synchronously agree the liquidation event in the articles of association of the target company, so as to facilitate the smooth exit of the investor

The Article 229 of the Company Law, which will be implemented on July 1, 2024, provides for several dissolution situations of the company: (1) the expiration of the business period stipulated in the articles of association or the occurrence of other dissolution causes stipulated in the articles of association; (2) the resolution of the shareholders' meeting for dissolution; (3) the need for dissolution due to merger or division of the company; (4) the business license is revoked, ordered to close down or cancelled according to law; (5) the people's court dissolves the company in accordance with the provisions of Article 231 of this Law. In practice, in addition to the aforementioned legal causes for dissolution, other dissolution and liquidation events are usually agreed in the investment agreement, such as the target company suffering serious losses and unable to operate within a certain period of time, but such events are not synchronized to the articles of association, that is, the investment agreement and the articles of association are not consistent on the company's liquidation events. At this time, if the investor only sues to dissolve the company and realize exit according to the liquidation events agreed under the investment agreement, there may be obstacles.

In (2020) Shanghai 02 Minzhong 782, the court believes that "after fact examination, Moluo Company (the target company) has not stipulated in the articles of association that the party violates the Investment Agreement and the investment purpose cannot be realized as the cause for dissolution of the company. The Investment Agreement is only an internal agreement between the parties before they become shareholders of the company, while the articles of association have the effect of public announcement when they are registered and filed with the administrative department. In the case that the content of the Investment Agreement is not clearly included in the articles of association, the investor becomes the shareholder of the company and should first be bound by the articles of association and the Company Law. However, the agreement of the Investment Agreement does not necessarily have the same effect as the articles of association, so the shareholder shall not take the violation of the Investment Agreement by other shareholders as the basis for the dissolution of the company...... Li Anlin claims that the dissolution of Moluo Company is not based on the provisions of the articles of association, nor has he provided sufficient evidence to prove that the company has met the statutory dissolution conditions, so the first instance court does not support his claim legally and accordingly." Combined with the above judgment views and relevant legal provisions, we tend to believe that the dissolution and liquidation of the company involves the treatment of external creditor's rights and debts, which should be subject to the provisions of the articles of association with the effect of public announcement. In the absence of the provisions of the articles of association, the investor sues for the forced dissolution of the company only according to the provisions of the Investment Agreement for liquidation events.

Therefore, it is suggested that the investor implement the special dissolution and liquidation condition agreed in the Investment Agreement in the articles of association of the target company synchronously. If relevant circumstances occur at that time, the company can be dissolved and exited according to the "other dissolution causes stipulated in the articles of association" stipulated in the Company Law.

In summary, in equity investment, the relevant parties usually focus on the core terms such as repurchase and betting, but the dissolution and liquidation clause of the target company is also a very important clause under the investment agreement. It is suggested that the investor strictly control the expression of relevant terms on the premise of respecting the basis of commercial negotiations of all parties, minimize the relevant risks to the greatest extent, and realize the smooth launch of the project.

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