An Analysis of Founder Liability Cap and Breach Exemption Clauses in Equity Investment and Financing Transactions

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In recent years, with an increasing number of cases where founders are held personally liable for their startup projects through put-and-call options or buyback provisions, founders' awareness of financing risks has become more direct. The negotiation on founder liability has become an important bargaining point for both investors and founders in equity investment and financing transactions. In response, the liability cap and breach exemption clauses, which are further extensions of founder liability, have been widely used to balance the risks of both parties. In fact, founder liability is often designed and reflected to different degrees in special rights clauses such as anti-dilution rights, valuation adjustment, and preferred liquidation rights, as well as in default liability clauses. Based on our project experience in equity investment and dispute resolution and current judicial practice, this article analyzes the liability cap and breach exemption clauses for founders, providing reference for all parties.

I. Limit of Liability for Founders

a. Limit of Liability for Repurchase Obligations under Repurchase Rights

In general, investors tend to treat the target company and the founders as joint repurchase obligors, jointly liable for the repurchase obligation or the obligation to pay repurchase consideration. If the founders cannot completely exclude their personal repurchase liability, in addition to trying to only bear supplementary liability within the scope where the company fails to fulfill the repurchase obligation, they can also seek to set a cap on their personal repurchase liability. In practice, the setting of founders' liability cap is often based on the equity

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shares of the target company held by the founders, such as assuming a limit of founder's repurchase obligations up to the number of the shares they hold or up to the value of those shares, respectively, with different statements corresponding to different ways of bearing liability. From the perspective of the founders, we suggest that the liability cap be explicitly set to the extent of repayment obligations arising from the disposal of all the shares held by the founders at the repurchase time, and explicitly exempting the founders' other personal property from liability. However, in order to prevent the founders from disposing their equity in a malicious manner, investors often require founders to dispose those shares in good faith at an appraised price, market fair price, or financing price, etc. At the same time, they will refine the determination mechanism and disposal mechanism of the above-mentioned prices, and the founders should also pay special attention to whether these detailed liability cap clauses will have any substantial consequence that affect the founder's other personal property in practice or not.

b. Founder's Liability Cap under Breach of Contract Clauses

Compared with the repurchase clause, founders may be more likely to overlook the breach of contract clause. In fact, no matter the general breach of contract clause or the special compensation clause, investors are accustomed to requiring the founders and the group company to bear joint and several liability for their losses. From the perspective of transaction, in addition to striving to set the liability cap limit based on the proceeds from equity disposal, founders may also try to negotiate for a deductible, a capped compensation amount, a list of special exemption scenarios, or limited liability for supplementary compensation.

c. Founder's Liability under Other Rights Clauses

As mentioned before, anti-dilution rights, preferred liquidation rights, and other investor-specific rights clauses often also include provisions on founder liability. Given that these provisions are typically scattered across lengthy transaction documents and have relatively complex mechanisms, we recommend that founders seek guidance from professional venture capital and financing lawyers.

II. The Founder's Liability Cap Exemption Clause and Its Recognition in Judicial Practice

When the founder's liability cap clause is reached, generally speaking, most investors will require to clarify the breach of the liability cap, such as agreeing that the founder is not protected by the liability cap clause if any fraud, intent or gross negligence incurs, or the founder and the target company carry out certain acts or under certain circumstances.

At this time, if the relevant parties in the transaction documents concretely and specifically break the founder's liability cap, the burden of proof of the claimants in the future dispute will be more clear and objective, and the possibility of being supported by the court will also increase.

In (2019) Shanghai 0115 Minchu 31035 case, the plaintiff (the investor) and the defendant (the founder) agreed in a Share Purchase Agreement signed by those two parties that if the original shareholder or management of the company has major personal integrity problems and fails to be diligent and responsible, resulting in major internal control loopholes of the company, the plaintiff shall have the option of requiring the defendant to repurchase the equity of the company held by the plaintiff in the form of cash. After the trial, the court found that the defendant used his personal bank account to conduct company activities and approved false or non-compliant accounting documents on his own, claiming a large amount of funds from the company, which clearly failed to fulfill his duties with due diligence. His conduct could not guarantee the authenticity and completeness of the company's financial information, and even endangered the safety of the company's assets and its legal and compliant operation. As a result, the court ruled that the repurchase conditions stipulated in the Share Purchase Agreement had been fulfilled, and the defendant was obliged to repurchase the plaintiff's stake in the target company at a stipulated price.

However, if the transaction documents do not clearly specify the specific circumstances in which the liability cap is breached, only vaguely summarize that the founder has committed fraud, intentional or gross negligence, etc., then disputes may arise among the parties as to whether the founder's relevant actions should be considered breaching the liability cap at that time. In this regard, we believe that the identification should be combined with the current laws and regulations and relevant judicial cases:

a. Identification of fraud

Article 148 of the Civil Code of the People's Republic of China stipulates: "If one party deceives the other party by using fraudulent means which results in the other party performs a civil legal act against its true intent, the party being deceived shall have the right to request the people's court or the arbitration institution to revoke this civil legal act." According to Article 21 of the Interpretation of the Supreme Court on several issues concerning the application of the General Provisions of the Civil Code of the People's Republic of China, if a party intentionally informs false information or the party with duty to inform intentionally conceals the truth, causing the other party to make a statement of intent based on a false understanding, the people's court can recognize it as fraud as stipulated in Articles 148 and 149 of the Civil Code. Thus, the elements of fraud include the intentional subjective state of the party, the objective behavior of informing the other party of false information or concealing the truth, and the causal relationship between the other party's incorrect statement of intent and the party's behavior.

In a share transfer dispute case (case No.: (2020) Xinmin Final 138), the court ruled that the target company's misconducts such as inflating deposits and profits, fabricating receivables, concealing obligation of guarantees and liabilities, as well as providing false information together with its actual controller and original shareholders, and other intentional fraudulent acts committed by the defendant (i.e., the share transferor) have constituted fraud against the plaintiff (i.e., the share transferee), and consequently, the court ruled in favor of the plaintiff's request to rescind the Asset Purchase Agreement between both parties. In series cases with case No. as (2021) Zhemin Final 171,

(2021) ZheMin Final 338, and (2021) ZheMin Final 83, the courts ruled that the founders of the target company had engaged in financial fraud by artificially inflating revenue and profits through methods such as faking online shopping orders and fabricating bank statements, and had also made up the company's operating performance, which has constituted fraud by third party. The courts therefore ruled in favor of the share transferee's request to rescind the 'National Property Transfer Contract' signed with the share transferor.

Although the above cases involve share transfer disputes between transferor and transferee other than involving the founder's obligation to repurchase shares and therefore did not directly related to the issue of breaching the founder's liability cap, however, all of these cases still involve the review and determination of fraudulent conducts made by the target company and/or the founder. We believe that the judicial view on identification of "fraud" according to the target company and/or the founder's misconducts such as falsely inflating revenue and concealing debts, is of great significance for the interpretation of whether the founder's behaviors can be deemed as "fraud" under the breach of founder's liability cap clause.

b. Identification of intention and gross negligence

Article 506 of the Civil Code stipulates that, "the following exculpation clauses in a contract are invalid: those resulting from intention or gross negligence causing damage to the other party's property", however, the Civil Code does not specifically define intention and gross negligence. As for the definition of intention, generally, it must meet the prerequisite conditions of knowing that damage will occur and intentionally causing it to occur. In terms of the definition of gross negligence, reference can be made to the Interpretation and Application of the Contract Law of the Civil Code, which refers to a type of fault between intention and ordinary negligence. The constituent elements of gross negligence include both a subjective requirement that the actor has knowledge or should have knowledge of the nature and harm of his/her conduct, as well as an objective requirement that the actor has created a huge danger. Whether a huge danger exists requires consideration from several perspectives, including the possibility of the danger turning into harm, the severity of the harm if it materializes, and the cost of the actor taking preventive measures.

In （2020） Beijing 01 Minchu 106293 case, concerning an "Overall Agreement on Share Transfer" (hereinafter referred to as "the Agreement") signed the plaintiff (i.e., the share transferee) and the defendant (i.e., the share transferor), the defendant argued that the losses incurred by the target company after the transfer of shares were due to the plaintiff's own reasons and therefore shall exclude the defendant's liability of share repurchase stipulated in the Agreement. The first-instance court's core view was that the term "major losses caused by one's own reasons" in the Agreement should indeed be understood as referring to the plaintiff's reasons, specifically including intention or gross negligence. However, in this case, the losses incurred by the target company after the share transfer were due to the company's normal business strategy choices, even if the choices made by the target company at the time had taken into account the advice or opinions of the plaintiff who had become a shareholder of the target company, it shall not therefore be considered as the plaintiff's intention or gross negligence. Therefore, the first-instance court held that the exclusion provision of the defendant's obligation of share repurchase stipulated in the Agreement did not apply, and ordered the defendant to fulfill the repurchase obligation. The second-instance court also ultimately upheld the original judgment.

This case still belongs to share transfer disputes between transferor and transferee and did not directly relate to the issue of the breach of the founder's liability cap, however, the court's analysis and argument on whether a specific behavior of the shareholder in the context of company operation constitutes intention or gross negligence reflects the judiciary authorities' cautious attitude towards identifying intention or gross negligence, which is worth learning from.

III. Summary

In summary, the founder's liability, liability cap, and cap-breaking provisions are extremely important and highly technical terms in equity financing transactions, we therefore suggesting that each relevant party should pay considerable attention to those relevant provisions within financing documents on the premise of respecting the basis of commercial negotiations, and they should simultaneously fully evaluate the actual executing effects of those provisions in subsequent judicial practice.

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