Scholar Publishing Group
International Journal of Business Management and Economics and Trade
https://doi.org/10.38007/IJBMET.2024.050108
ISSN 2790-0959 Vol. 5, Issue 1: 57-71

The Interpretation of the Interest Balance Mechanism of Valuation Adjustment Mechanism—Reflection on the Identification of Valuation Adjustment Mechanism in the Minutes of the Ninth National Civil and Commercial Trials Work Conference

Huiming He[1,*], Qingwei Li[2]

[1]*Economics School Shanghai University, Shanghai, China*

[2]*Law School Shanghai University, Shanghai, China*

[*]*Corresponding author*

Keywords: Valuation Adjustment Mechanism, Information Asymmetry, Agency Cost, Interest Balance, Valuation

Abstract: Valuation Adjustment Mechanism refers to an agreement in equity financing agreements that contains transaction arrangements for future uncertain matters such as equity repurchase or cash compensation. As a core clause that occupies an extremely important position in equity investment agreements, investment institutions almost take the valuation adjustment clause as a prerequisite for investment. Its validity and enforceability are related to the survival bottom line of investment institutions. The continuous revision of the determination of the validity of the agreement in judicial practice makes the performance of the Valuation Adjustment Mechanism uncertain. Starting from the economic benefit starting point of the Valuation Adjustment Mechanism, this article expounds the business purpose and concerns of investment institutions. Through case retrieval, analyze the stages and basis of judicial judgments on the validity of the Valuation Adjustment Mechanism; analyze the positive effects brought by the Minutes of the National Courts' Work Conference on Civil and Commercial Trials (hereinafter referred to as the "Minutes of the Ninth National Civil and Commercial Trials Work Conference"), and at the same time analyze its shortcomings. The simple handling of the judgment on the performance of the Valuation Adjustment Mechanism has led to damage to business purposes. It is recommended to start from the principle of capital maintenance and the solvency of the enterprise to achieve a balance of interests among investors, creditors and the company.

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1. Introduction

In today's complex and ever-changing business environment, equity investment and financing activities are becoming increasingly frequent, among which the Valuation Adjustment Mechanism (VAM) has become a focus of much attention. As a common arrangement in equity financing agreements, VAM aims to address issues such as the uncertainties of the future development of the target company, information asymmetry, and agency costs.

The concept of "Valuation Adjustment Mechanism (VAM)" originated from overseas investment and financing practices, but its first appearance in the fields of finance and judiciary in China can be traced back to the 1990s. Initially, it manifested as an over-the-counter trading behavior of futures brokerage companies. In current equity investment practices, it is often regarded as a gambling agreement. There are various viewpoints in the academic circle regarding its nature and scope. Some believe it is a financing contract to solve the problem of enterprise valuation, some consider it a form of option, and others think it is a means to address the information asymmetry between the investor and the financier.

In the process of investment and financing, the emergence of the VAM phenomenon has its underlying reasons. From the perspective of the investor, risk control is key. VAM helps avoid the deviation in profit forecasts caused by information asymmetry. At the same time, to ensure a smooth exit, the equity repurchase clause emerges. Information asymmetry is particularly prominent in investment activities, running through stages such as pre-investment research, agreement negotiation, and post-investment management, which may trigger adverse selection and moral hazard. Moreover, agency costs are also one of the influencing factors. Investors set a series of rights to reduce moral hazard, but objectively this leads to an increase in agency costs.

In VAM, the investor and the financier engage in an interest game and adjust the valuation based on the performance of a certain period in the future to achieve an interest balance. However, there are imbalances in the determination of VAM disputes in judicial practice. For example, in disputes where the investor takes the target company as the VAM subject, courts usually determine that the VAM clauses are invalid, which to a certain extent harms the interests of the investor.

The relevant minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference provide trial principles for the handling of VAM disputes, attempting to seek a balance between encouraging investment, maintaining capital, and protecting the legitimate rights and interests of creditors. However, there are still some problems in practice, such as excessive protection of the interests of creditors and the coordination of conflicts between different legal concepts.

2. The Definition of Valuation Adjustment Mechanism (VAM) in the Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference

The practical circle generally believes that "Valuation Adjustment Mechanism (VAM)" originated from overseas investment and financing practices. However, in fact, the term "VAM" first appeared in the Chinese financial and judicial fields and can be traced back to the 1990s. At that time, "VAM" referred to an over-the-counter trading behavior of private hedging conducted by futures brokerage companies [1]. At this stage, it is usually understood as a gambling agreement in equity investment practice. There are many paper to make the point concerning the gambleing agreement in academic circle, such as Mr Li Jinhua [2] think that VAM is a financing contract related to the valuation of enterprises, Hai xia Xie’s [3] believes that VAM is actually a form of option and is essentially a means to solve the problem of information asymmetry between investors and investees, the opinion of YuQiuWei, Xia Qing [4] is an adjustment mechanism arising from the uncertainty of the valuation of the financing enterprise between the two sides of investment and financing, Zhang Xianzhong [5] believes VAM is that when the two sides of investment and

financing fail to achieve the agreed operating performance of the target company within the agreed time limit, the equity ratio is adjusted or an alternative method with the same commercial effect is adopted.

The Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference defines VAM as an agreement that contains equity repurchase, monetary compensation, and other adjustments to the valuation of the future target company designed by the investor and the financier when reaching an equity financing agreement to address the uncertainties, information asymmetry, and agency costs regarding the future development of the target company. [6]

There are many discussions on the scope of the terms of VAM. Professor Liu Yan summarized three different scopes: The narrowest scope only refers to the pricing adjustment clause of the initial investment, that is, in view of the differences in equity valuation between the investor and the financier, both sides agree to use the performance achieved by the company after a specific time as the standard, or to compensate the investors with excessive investment, or to require the investors with insufficient investment to increase their capital contributions; The medium scope interpretation, "VAM" includes the aforementioned initial investment pricing compensation clause and the share (equity) repurchase clause when the investor exits, the latter usually occurs when the invested enterprise fails to successfully achieve an IPO listing; The broadest scope vaguely expresses "VAM" as the agreement made by the investor and the financier regarding "future uncertain situations". According to the actual profitability of the future enterprise, the investor or the financier obtains certain rights as compensation. In this understanding, VAM can also be regarded as a synonym for the PE/VC investment contract. [7]

The Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference includes equity repurchase in VAM. For the convenience of discussion, this article will adopt the medium scope definition and include both the performance valuation adjustment mechanism and equity repurchase in VAM for discussion.

3. Valuation Adjustment Mechanism (VAM): Why VAM?

In the process of investment and financing, why does the phenomenon of VAM occur? In other words, why is the transaction structure of VAM established in the process of investment and financing? Some views hold that the core of the VAM aims to solve the valuation dilemma of start-up enterprises [8], and the most core reason for the valuation dilemma lies in solving the extreme uncertainty, information asymmetry and agency cost problems faced by investors in the face of financiers [9]. The aforementioned view holds that valuation difficulties are the main reason for the emergence of VAM, and then analyzes the three elements that lead to valuation difficulties. These analyses have certain rationality, but the argument is slightly insufficient. This article intends to analyze the commercial purposes of all parties in the VAM process based on the operation mechanism of the investor, combined with the current situation and interest demands of the enterprise of the financier. Furthermore, it is believed that the VAM process is actually a process of balancing the interests of all parties, and the VAM is the result of weighing the interests of all participants in the VAM.

(1) The Operating Mechanism of the Investor: The Trade-off between Benefits and Risks

In the process of venture capital investment, investment involves risks, and thus prudent investment has become common sense. Therefore, as an investor, risk control is the main consideration in the investment decision-making. With the development of risk prevention theories, the mechanisms for preventing risks have become increasingly diverse. In the process of equity investment and financing, the exit mechanism of venture capital funds is an effective mechanism for controlling risks. It is oriented towards the exit of investors, obtaining equity through

high-premium investment, and exiting after obtaining capital appreciation. The best investment method for venture capital is to successfully list the invested company and thereby obtain returns during the duration. Today Capital's investment in JD Mall yielded a return of more than 150 times, becoming a classic case that must be mentioned in the investment circle [10], Xu Xiaoping's investment of 180,000 US dollars in Jumei Youpin, and the value of this portion of stocks was as high as 300 million US dollars, which has become a well-known story in the industry [11]. After all, the above cases are not replicable and are almost legendary. According to the data released by Private Equity Connect, Shenzhen Capital Group's investment in Beijing Easpring Material Technology Co., Ltd. had a return rate of 26 times, and its investment in Shenzhen MTC Co., Ltd. had a return rate of 16 times, which is more in line with the normal investment rate of return of high risks and high returns [12].

Investment institutions invest in enterprises at a high premium, and their valuation of enterprises has its inherent logic and calculation methods, including price-to-book ratio, price-to-sales ratio, effective number of users, etc., which are applicable to different industries. The prediction of the target company's performance is the main basis for investors' valuation. The initial purpose of the valuation adjustment mechanism (VAM) is to avoid the deviation in profit forecasts caused by information asymmetry, and it is undoubtedly the best way to avoid the trap of high valuation.

The duration of investment institutions is relatively short, usually ranging from seven to ten years. During the duration, they need to complete project investment, project management, and project exit. The exit of investment projects, the securities market is the best choice. The core reason lies in obtaining the high returns brought by the high valuation of the exit from the public market. However, there is great uncertainty in exiting through listing. Shenzhen Capital Group, which has the largest number of investment enterprises and listed enterprises among domestic equity investment institutions, as of the end of February 2020, has invested in 1,082 projects, and 160 investment enterprises have been listed on 16 global capital markets respectively. This is already an enterprise at the forefront of the success rate in the investment industry, and the proportion of listed enterprises is less than 15% [13]. The opening of the STAR Market in 2019 has expanded the exit channels for investment institutions. According to the data of Zero2IPO Research Center [14], a total of 2,949 exits occurred in China's equity investment market in 2019, among which 1,573 IPOs of invested enterprises occurred, accounting for 53.3% of the total exits. Under the current situation where IPO exits cannot meet all exit requirements, exiting through overall mergers and acquisitions will also obtain good returns. In 2019, the number of exits through mergers and acquisitions was 412, accounting for 14%. In order to ensure a smooth exit before the expiration of the fund's duration, the equity repurchase clause emerged as a guaranteed path for investors to exit their investments. The main body of the repurchase clause is usually the actual controller or the target company. Considering that the actual controllers of start-up enterprises usually have no other significant assets for repurchase except for the target company, and the investment funds are invested in the target company. It has also become an inevitable demand for investment institutions for the target company to repurchase the equity of the investment institution.

(2) Information Asymmetry

The concept of information asymmetry originated from the information asymmetry theory proposed by Akerlof (G, 1970), which pointed out: "The information held by both the buyer and the seller in the market is different. Usually, the seller has more complete information while the buyer has incomplete information." [15] In the case of information asymmetry between the two parties in a transaction, one party, for its own interests, takes advantage of its information superiority and chooses behaviors that are unfavorable to the other party, thereby triggering the two core contents in the information asymmetry theory: adverse selection and moral hazard. Adverse selection refers to the party with more information obtaining additional benefits by using the information that the

counter party does not have. Moral hazard refers to the behavior of the party with information superiority deliberately hiding relevant information for its own interests and causing damage to the other party. [16] However, information asymmetry is particularly prominent in venture capital activities, which runs through all links such as pre-investment research, investment agreement negotiation, and the management of the invested enterprise after the investment is completed. [17]

There is obvious information asymmetry between investors and founders of potential investee enterprises throughout the process from investment decision-making to investment contract negotiation. The process from a venture capital institution contacting a start-up enterprise to completing the investment payment usually lasts only two to four months. It is almost impossible to conduct a comprehensive understanding of a start-up enterprise in all aspects of its intrinsic commercial value, law, and finance. Relatively speaking, the financier is well aware of its own advantages and disadvantages, has a clear understanding of the strengths and weaknesses of the core team members, and is fully informed about the market prospects of the product and the signing and execution of orders. The most core issue is that, in the case of information asymmetry, potential investee enterprises tend to selectively disclose information, exaggerate favorable information and hide negative information in order to obtain a higher investment amount, more favorable investment conditions, and further reduce the risks that their enterprises need to bear. This is to maximize their own interests in the investment negotiation game, thereby triggering the problem of adverse selection.

After the completion of the investment, there is still information asymmetry between the investor and the investee enterprise. The operating model of the investor side, usually as a financial investor, does not directly participate in the daily operation and management of the investee enterprise. The founders of the investee enterprise are in a more superior position in terms of information in all aspects of the enterprise compared to the investors. When there is a conflict of interest between the investee enterprise and the investor, such as in subsequent financing and performance assessment, etc., it may lead to the "adverse selection risk" of the investee enterprise. Even if the venture capital fund has guaranteed the right to obtain key information through the full information right clause, these measures can only play a partial preventive role and cannot fully protect the rights and interests of the investor. Businessmen pursue profits. Both the investment and financing parties are businessmen. Then they will use the ultimate weapon, taking interests, namely cash, equity, or even the transfer of management rights as chips. If the founding shareholder team, as the management, operates the company with performance lower than expected, they will compensate with cash, additional equity, or lose the management rights of the start-up enterprise. In the face of actual economic interests, the management will carefully weigh the pros and cons before they are about to conduct moral hazard behaviors that damage the interests of the venture capital fund based on information asymmetry.

(3) Agency cost

The so-called agency costs, as classically discussed by Jensen and Meckling, refer to the costs incurred by the principal to motivate the agent and the agent to guarantee the principal's interests based on the divergence of interests between the principal and the agent to prevent the agent from damaging the principal's interests." [18] Any system designed to reduce a certain type of agency cost is itself a principal-agent arrangement that will introduce a new, seemingly more economical principal-agent relationship. In the presence of asymmetric information and moral hazard, over time, no agency system can escape the trap of agency costs. [19]

In the valuation adjustment mechanism (VAM) arrangement of equity investment, due to information asymmetry, various moral hazards can be triggered. In the relevant systems of the Company Law, such as the information disclosure system, the fiduciary duty of directors, the independent director system, the external monitoring system, and the shareholder representative

litigation system, investors also obtain sufficient information rights through the adjustment of the corporate governance mechanism of the investee enterprise, set up the rights and limitations of the shareholders' meeting, the board of directors, the board of supervisors, and the management layer to prevent the founder shareholders from being arbitrary and making wanton decisions, as well as the veto power for major matters, and a series of priority rights such as the priority dividend right, the priority purchase right, the priority liquidation right, the drag-along right, and the tag-along right, in order to reduce this moral hazard. However, this objectively leads to an increase in agency costs. In the case where the setting and implementation of various systems will increase costs, investors use economic interests as chips and operating performance as the evaluation criterion, perfectly avoiding the trap of agency costs generated by the implementation of a series of systems.

(4) Valuation Adjustment Mechanism (VAM) is the Balance of Interests Reached After the Game Between the Investor and the Financier

From the perspective of the financier, it is indeed a difficult choice to accept that the failure of the VAM may lead to the loss of the company's control or the exhaustion of all resources to pay the investment funds to the investor. Most of the investment agreements provided by the investor are standard terms, and the financier mostly has no right to negotiate. The content of rights and obligations is more advantageous to the investor, and the financier will first consider the entire agreement to be grossly unfair and imbalanced in interests.

From the perspective of the investor, the biggest disadvantage lies in the serious information asymmetry about the target company. There are natural obstacles to obtaining information about the target company before the investment, and the problem of information asymmetry still exists after the investment. The fundamental starting point of signing the "valuation adjustment mechanism (VAM)" is mainly to reduce the high risks of the investor during the investment and to address the uncertainty of the future development and profitability of the enterprise. [20]

The basis for the achievement of investment is the consensus reached by both the investor and the financier on the valuation of the target enterprise. Investors tend to conduct valuation according to a valuation system that is beneficial to them, while financiers choose overly optimistic or completely fanciful performances as the basis for valuation. It is difficult for both the investor and the financier to reach an agreement on the valuation. In order to reach a consensus on the valuation and seek the balance of interests between the two parties, both the investor and the financier take the performance of a certain period in the future as the standard. When the performance assessment point arrives, the difference between the actual achieved performance and the predicted performance is used as the calculation base, and the valuation is adjusted through equity transfer or cash compensation. Under the arrangement of the valuation adjustment mechanism (VAM), both the investor and the financier can temporarily set aside the issue of the enterprise value and come back to evaluate the enterprise at a certain point in the future. [21] To prevent either party of the investment and financing from suffering losses due to the overvaluation or undervaluation of the enterprise value and achieve the balance of interests of both parties. [22] In the author's opinion, the conclusion of the VAM clause is the product of the balance of interests reached after the game between the investor and the financier, and it plays a crucial role in enabling the smooth progress of the investment.

(5) Imbalance of Interests in the Recognition of Valuation Adjustment Mechanism (VAM) Disputes in Judicial Practice

On the two judgment document websites, China Judgments Online and Wolters Kluwer, using the keyword "valuation adjustment mechanism (VAM)", with the time range defined from January 1, 2014 to November 1, 2019, and limited to the Supreme People's Court and the cities of Beijing, Shanghai, Guangzhou, and Shenzhen, a total of 78 cases involving disputes over the VAM (valuation adjustment) clauses were retrieved, among which there were 48 first-instance cases and

30 second-instance cases.

An analysis of the above 78 cases reveals that the disputes in these cases mainly focus on issues such as whether the VAM clause is valid, whether it constitutes a VAM clause, the scope involved in the VAM clause, whether the VAM (performance) has been completed, and whether the VAM clause has been lifted. The case with the largest number and the most significant dispute is undoubtedly whether the VAM clause is valid. Among them, in the cases of VAM clause disputes where the investor takes the shareholders or actual controllers of the target company as the VAM subjects, the courts all determined that the VAM clauses were valid (32 cases in the first instance and 22 cases in the second instance). In the cases of VAM clause disputes where the investor takes the target company as the VAM subject, the courts generally determined that the VAM clauses were invalid (5 cases in the first instance and 4 cases in the second instance) (Detailed data are shown in Figure 1).

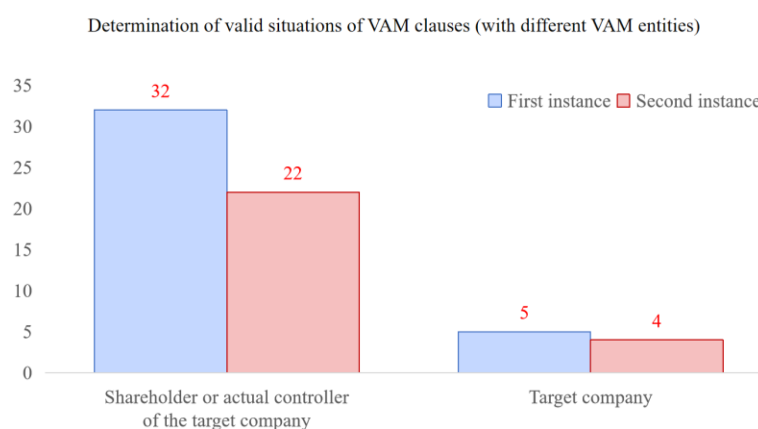

Figure 1: Determination of valid situations of VAM clauses (with different VAM entities)

In the above cases, the judicial authorities have no dispute over the validity of the VAM clauses where the investor takes the shareholders or actual controllers of the target company as the VAM subjects. However, the VAM with the target company is all judged invalid. For the investor, the investment funds are injected into the target company, and most shareholders of start-up companies have no ability to perform the repurchase obligation. In the situation where the investor's claim for the VAM agreement with the target company is not supported, it undoubtedly causes significant damage to the investor's interests. The judicial authorities overly emphasize the protection of the interests of creditors and ignore the balance of the interests of the investors, resulting in an imbalance of the interests of the investors. The Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference has fully noticed this tendency and attempts to correct it.

4. Reflection on the Balance of Interests in Valuation Adjustment Mechanism (VAM) in the Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference

The Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference, regarding the tendency and practice of overly emphasizing the protection of investors in judicial practice, specifically proposed the trial principle for VAM disputes as: "When the people's courts hear cases of disputes over 'valuation adjustment mechanism (VAM)', they should not only apply the relevant provisions of the Contract Law but also the relevant provisions of the Company Law. They should not only adhere to the principle of encouraging investors to invest in physical enterprises, especially technological innovation enterprises, thereby alleviating the financing

difficulties of enterprises to a certain extent, but also implement the principle of maintaining capital and protecting the legitimate rights and interests of creditors, and balance the interests among investors, creditors of the company, and the company in accordance with the law." [23]

(1) The Gains in the Balance of Interests Regarding Valuation Adjustment Mechanism (VAM) in the Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference

The judicial practice's judgment rules on disputes over VAM have roughly gone through the following stages from the Supreme People's Court's judgment in the Haifu case that caused a stir in the investment community to the conclusive determination of the validity of VAM in the Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference.

The first stage took the legality judgment of VAM as the core of judicial judgment. In the Haifu case [24], the fixed income obtained by Haifu's investment was detached from the operating performance of Shiheng Company, damaging the interests of the company and the company's creditors. The core viewpoint of the trial was that the contract terms violated the mandatory norms of the Company Law, resulting in the invalidity of the contract, forming an interpretation that VAM with shareholders was valid while VAM with the target company was invalid, which was regarded as a guiding principle for a time. "Invalidity" is a complete denial of contractual autonomy, and venture capital is highly dependent on contractual order [25]. Pan Lin believes that the judgment of the Haifu case, as an important sample of the intervention of company law regulation in contractual autonomy in financial innovation, has problems such as the paradox of the regulatory purpose and the legal consequence of contract invalidity, the arbitrary bundling of mandatory norms and contract validity, and the misunderstanding of detailed regulatory methods, which have problems of detaching from, suppressing and distorting, and obscuring private choices [26]. Professor Liu Yan believes that the core of the judgment of VAM lies not in the legality judgment of the transaction type but the possibility of contract performance, the latter of which needs to be analyzed specifically based on the company's financial situation. Even if PE conducts cash VAM with the company, it may be legitimate if it does not damage the company's capital and solvency. [27]

The second stage took the legality judgment of VAM as the core of judicial judgment, combined with the principle of maintaining capital, and partially supported the repurchase claims of investment institutions. In the case of Shandong Hanlin [28], the court supported the litigation request of the investment institution that Hanlin Company and Cao Wubo jointly repay 42 million yuan as the provident fund portion and its capital cost and interest losses. The repayment of the investment funds by the target company into the provident fund portion is not considered a violation of the principle of maintaining capital. The logic of this core viewpoint lies in distinguishing the investment funds into registered capital and capital reserve, and determining that the principle of maintaining capital is limited to the registered capital.

The third stage adopted the separation of contract validity and contract performance. The Huagong case [29] established the judgment logic that the company's repurchase of its own shares does not necessarily violate the mandatory provisions of the Company Law, and further introduced the judgment idea of judging the possibility of contract performance, which is a significant improvement compared to previous cases. However, the Huagong case still has many issues worthy of discussion. The most controversial one is that the judgment believes that the limited company's implementation of the capital reduction procedure will not damage the interests of the company's shareholders and creditors, nor will it constitute a violation of the principle of maintaining the company's capital. The repurchase of the company's shares involves share delivery and payment of the price, which depends on the completion of the capital reduction procedure. However, the capital reduction procedure has not yet been completed, and the repurchase price needs to be paid after the judgment. This judgment undoubtedly bypasses the legal procedure of capital reduction, and even procedural justice cannot be guaranteed. I don't know where the confidence comes from to say that

it will not damage the interests of the company's shareholders and creditors as stated in the judgment.

The fourth stage, the release of the Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference, is like clearing the fog and seeing the blue sky, abruptly ending the dispute over the validity of VAM, determining the principle that VAM with the target company is not necessarily invalid. Instead of distinguishing the validity of VAM by the VAM subject, it returns the validity judgment of VAM to its essential nature, and determines the judgment rule that if there is no legal cause for invalidity of the contract, the VAM contract with the target company is valid. At present, the core logic of the contract validity issue related to mandatory norms in judicial practice [30], has changed, realizing the separation of contract validity and contract performance. In addition, obstacles to contract performance that do not comply with the mandatory provisions of share repurchase and profit distribution are no longer used as the basis for judging the validity of VAM contracts, but the principles that equity repurchase is based on capital reduction and cash compensation is based on profit distribution are determined. Although the Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference is not a judicial interpretation and does not have a mandatory legal effect, it reflects the intention of the highest judicial adjudication institution to seek a balance between the protection of investment and financing and the legitimate interests of creditors, providing guidance and direction for judicial practice.

(2) The Losses in the Balance of Interests Regarding Valuation Adjustment Mechanism (VAM) in the Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference

The view of the Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference that if the VAM agreement with the target company has circumstances where it cannot be performed legally, the VAM request of the investor will be rejected. In fact, there is still suspicion of excessive protection of the interests of creditors without sufficient attention to the interests of the investors.

The Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference pointed out that if the VAM agreement with the target company has "circumstances where it cannot be performed legally, then according to Article 110 of the Contract Law, the litigation request of the investor to perform the above-mentioned agreement should be rejected." Article 110 of the Contract Law [Article 110 of the Contract Law stipulates that if a party fails to perform a non-monetary obligation or the performance of a non-monetary obligation does not conform to the agreement, the other party may request performance, except under any of the following circumstances: (1) The performance is legally or factually impossible; (2) The subject matter of the obligation is not suitable for compulsory performance or the cost of performance is excessively high; (3) The creditor fails to request performance within a reasonable period.] stipulates three legal circumstances where "non-monetary obligations" cannot continue to be performed. The author understands that the legal obstacles here mainly refer to the requirements in the Company Law regarding share repurchase and surplus distribution.

From the perspective of the purpose of contract formation, any party entering into a contract aims to realize the content of the contract. The realization of the contract content depends on the performance of the contract obligations. The performance of the contract is the central content of the contract system and the ultimate destination or extension of the Contract Law and all other systems. The prevailing view in the academic circle is that impossibility of performance includes physical impossibility and also includes the inability of the debtor to fulfill the debt according to social concepts and trading habits.

The obligation of the target company to repurchase equity mainly involves matters such as the payment of the equity price and the industrial and commercial change registration of the equity. Among them, the payment of the equity price and cash compensation are typical monetary debts.

Article 109 of the Contract Law stipulates: "If a party fails to pay the price or remuneration, the other party may request it to pay the price or remuneration," and there are no exception rules. The underlying meaning is that monetary debts are not applicable to the rules of Article 110 of this law. Article 110 of the Contract Law more clearly states that only "non-monetary debts" are applicable to this rule. However, in the contract with the company for VAM, the creditor's rights that the investor enjoys against the target company when filing a lawsuit almost all belong to monetary creditor's rights. The Contract Law stipulates that there is no circumstance where monetary debts cannot be performed in the contract. Therefore, the court's rejection of the investor's request for the target company to perform the obligation of equity repurchase or cash compensation based on the existence of legal obstacles according to Article 110 of the Contract Law is not reasonable.

The court's judgment on the performance of the VAM agreement is based on the contract performance rules of the Contract Law and the provisions of the Company Law on share repurchase and surplus distribution. In fact, the legal concepts upheld by these two different legal relationships conflict. The VAM agreement embodies the spirit of contractual freedom, while the Company Law embodies the state's intervention in the freedom of commercial activities. In China's current law and its development stage, the conflict between these two legal concepts has not been effectively coordinated, but this coordination has reached a stage that must be resolved. Because if this problem cannot be effectively solved, it will greatly harm the business model of equity investment. The Minutes of the Ninth National Courts' Civil and Commercial Trial Work Conference determined that the performance of the VAM agreement is linked to the company's profits. The VAM agreement was originally based on profits. If the performance is determined based on the presence or absence of profits, it has violated the original intention of the agreement, making the performance impossible, and the most basic guarantee on which equity investment relies has become a paper right, and the cornerstone of the business model has almost been destroyed. [31]

(3) The Balance of Interests with Creditors

To achieve a balance of interests with creditors, on the one hand, the interests of creditors need to be protected and be subject to the regulation of the principle of maintaining capital. On the other hand, more attention needs to be paid to the solvency of the company to determine that while the investor implements the performance of the VAM agreement, it does not affect the solvency of the company to protect the interests of creditors. The core issue lies not only in the integration and separation of the contract legal system and the company legal system but also in the necessity of using financial accounting knowledge and transaction experience to assist in the interpretation and application of the law.

The Principle of Maintaining Capital:

The principle of maintaining capital represents the commercial concept of capital credit and emphasizes the important value of shareholders' contributions in safeguarding the interests of creditors. Capital credit is manifested in the legal capital system and the implementation of the three principles of capital determination, capital maintenance, and capital invariance. The most classic exposition of the principle of maintaining capital: There is no doubt that capital will be consumed due to being invested in the normal business scope of the company; some of it may also be lost in the business authorized by the company. All those who trust the company and conduct transactions with the company are aware of and willing to bear these risks. However, they have the right to rely on, and the company legislation also intends for them to rely on the company's guarantee that the company's capital will not be consumed beyond the above-mentioned business purposes nor be reduced by being returned to shareholders. [32]

The provisions of German company law have made a clear elaboration on the principle of maintaining capital. "Even if the original capital has been actually paid once, there is no issue of protecting it from adverse business damage, but the law can prevent shareholders from withdrawing

capital from the company... The principle of maintaining capital should be understood in this sense, that is, the law protects the company's assets from being infringed by shareholders within the scope of the original capital amount. This distribution prevention is also known as the pillar or core of limited liability company law." [33]

The viewpoint of Judge Du Jun of the Supreme People's Court represents the viewpoints in some judicial practices. The principle of maintaining capital is to establish a connection and bond between the net assets of the company and the static registered capital figure, so that the amount of the company's net assets is always maintained at or above the level of the registered capital figure. The principle of maintaining capital not only requires that the net assets be maintained above zero to fully settle the interests of existing creditors but also requires that the net assets be maintained above the registered capital to convey true net asset information to potential creditors. [34]

For maintaining capital, the registered capital is the lower limit of the company's external liabilities. For creditors, it is based on the sufficient trust in the sufficient registered capital that they are willing to cooperate with the company. The reduction of capital will have an impact on the interests of creditors. However, commercial cooperation is far from being as simple as the law stipulates. The registered capital that the creditor's reliance interest points to is the registered capital at the time of the conclusion of the cooperation. But what if the company undergoes capital increase and then capital reduction after that, and the registered capital after the capital reduction is higher than the registered capital at the time when the creditor contracted? Will this capital reduction have an impact on the creditor's interests?

Measuring the company's solvency by the registered capital is like deceiving oneself. During the company's operation, the net asset value and the registered capital are constantly changing due to profits and losses. The investor invests in the company at a high premium and only holds a small portion of the equity. The increase in the net assets of the investee company will far exceed the increase in the registered capital. The registered capital that creditors rely on is actually far lower than the net assets of the company at that time. In addition, the existence of a VAM agreement in the company belongs to the public announcement matter in the company registration authority. Instead of the judicial practice's excessive interference in commercial judgment, which artificially breaks the harmonious coexistence of the VAM agreement and the principle of maintaining capital, it is better to formulate a more transparent and strict public announcement system, fully disclose risks to creditors, return commercial judgment to businessmen, to protect the business model of equity investment and be more conducive to the development of start-up enterprises.

In the author's view, the valuation adjustment mechanism (VAM) and capital maintenance are not incompatible. The core of the principle of capital maintenance lies in protecting the company's assets from being diminished by being returned to shareholders, thereby damaging the legitimate interests of creditors. In the process of the company's operation, there are obvious differences in the amounts between net assets and registered capital at different points in time. The investor's investment method is to invest in the company at a high premium but only holds a small portion of the equity, and the increase in the net assets of the invested company will far exceed the increase in the registered capital. The registered capital that creditors rely on for trust is actually much lower than the net assets of the company at that time. In addition, the existence of a VAM in the company originally belongs to the matter for public announcement at the company registration authority. Instead of the excessive interference of judicial practice in commercial judgment, which leads to the artificial disruption of the harmonious coexistence of the VAM and capital maintenance, it is better to formulate a more transparent and strict public announcement system, fully disclose risks to creditors, return commercial judgment to business people, to protect the business model of equity investment and is also more conducive to the development of start-up enterprises.

The logical foothold of the Company Law in protecting creditors is that the company's solvency

that creditors rely on should not be reduced due to the withdrawal of capital by shareholders. It is rather far-fetched to judge whether the company's performance of the repurchase obligation to the investor based on the registered capital and net assets based on the principle of maintaining capital constitutes an infringement of the interests of creditors. Based on this, solvency is a better indicator of the company's solvency.

Solvency:

Unlike the principle of maintaining capital which emphasizes capital credit, the solvency standard can truly determine the company's debt-paying ability. The protection of creditors' interests should pay more attention to the company's solvency, which is the core to guarantee the interests of creditors. The solvency test is undoubtedly the benchmark for judging whether the execution of the valuation adjustment mechanism (VAM) will infringe on the interests of creditors.

Section 6.40(c) of the Revised Model Business Corporation Act issued by the American Bar Association in 1979 stipulates: "A distribution may not be made if: (1) the corporation would be unable to pay its debts as they become due in the usual course of business after the distribution; or (2) the total assets of the corporation would be less than the sum of its total liabilities plus, unless the articles of incorporation permit otherwise, the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution." This provides a relatively clear regulation on the solvency test.

According to the above solvency standard, it involves complex financial calculations. The author believes that it is almost impossible to obtain an accurate calculation result that is commonly recognized without the in-depth participation of professional accountants. In the case where the repurchase agreement in the VAM with the company is valid, if the court determines that the company's performance of the repurchase obligation will damage the company's solvency, it will reject the investor's request for payment of the repurchase price. The basis for the court's judgment of solvency has become the focus of the debate.

5. The Path to Balance the Interests of Investors, Creditors and Companies

He court has shifted the judgment of the principle of maintaining capital and the solvency of the company from the focus on the validity of the contract to the stage of contract performance, and should pay more attention to balancing the interests of creditors, investors and the target company. The court or the parties will rely more on professionals (such as certified public accountants, etc.) and combine the financial data such as the net cash flow generated from the operating activities of the target company to accurately judge the cash flow of the target company, and then determine whether the target company can perform the repurchase obligation (whether it impairs the solvency of the target company). [35]

In this context, to balance the interests of all parties, the flexibility and diversity of the ways to assume liability for breach of contract should be achieved on the premise of the validity of the contract. The mechanisms of Contract Law and Company Law, substantive law and procedural law can be comprehensively applied. Based on the financial situation of the company, the compensation or repurchase funds can be paid in installments or deferred until the performance interests of the investors are met under the premise of maintaining capital. [36]

Domestic listed companies and the National Equities Exchange and Quotations System have clear standards for equity repurchase, which play a good guiding role in balancing the interests of investors, creditors and companies.

(1) The relevant provisions of the "Notice of the China Securities Regulatory Commission on Issuing the 'Administrative Measures for the Repurchase of Public Shares by Listed Companies

(Trial)' " (CSRC [2005] No. 51, hereinafter referred to as: the "Notice") regarding the principles and measures for the sustainable development of companies and the protection of creditors are worth learning from: One of the conditions for a listed company to repurchase shares is that after the repurchase of shares, the listed company has the ability to continue operating. The listed company shall hire an independent financial advisor and a law firm to issue professional opinions on the matter of share repurchase. The independent financial advisor shall conduct due diligence on the matter of share repurchase by the listed company, issue an independent financial advisor report, and announce it in the newspapers and periodicals designated by the China Securities Regulatory Commission 5 days before the shareholders' meeting. One of the contents of the independent financial advisor report shall be to analyze the impact of the share repurchase on the company's daily operation, profitability and debt-paying ability by combining factors such as the funds required for the share repurchase and its sources, and explain the feasibility of the repurchase plan.

(2) The "Notice of the Limited Liability Company of the National Equities Exchange and Quotations System on Regulating the Share Repurchase Business of Quoted Companies" issued on April 12, 2019, clarified the reference indicators for determining the scale of share repurchase by non-listed public companies. The notice stipulates that the quoted company should reasonably determine the repurchase scale in combination with factors such as the purpose of the repurchase, financial status, business situation and cash flow. The repurchase scale can be determined by choosing either the total amount of repurchase funds or the total amount of repurchased shares, and the repurchase plan should include a clear upper limit on the number of repurchased shares. For situations such as large-scale debt-based repurchase, the company's undistributed profits being negative or the repurchase may cause undistributed profits to be negative, the sponsoring securities firm should conduct a detailed analysis of the necessity, feasibility and rationality of the company's implementation of the repurchase; focus on changes in financial indicators such as the company's net profit, undistributed profits, monetary funds, asset-liability ratio, current ratio, and quick ratio before and after the repurchase, and whether it is suspected of using the repurchase for excessive profit distribution; fully assess the impact of the repurchase on the company's ability to continue operating and its debt-paying ability, and carefully issue opinions that are legal and compliant.

The above provisions have established a rule system on how to ensure the company's solvency and sustainable development ability and its safeguard measures, and have practical experience of successful operation. They provide clear guidance for investors to fulfill the repurchase of the valuation adjustment mechanism (VAM), and well achieve the balance of interests among investors, creditors and the company.

Finally, the author believes that the idea of "interest balance" runs through the handling of the issue of valuation adjustment mechanism (VAM) all the time. As the balance of interests reached after the game between the two sides of equity investment and financing, the valuation adjustment mechanism (VAM), without infringing on the interests of third parties, judicial practice should follow the commercial essence and should not interfere too much.

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