Dealing with China's gambling problem

The valuation adjustment mechanism protects investments through a series of contracts, but a recent court case held a contract void, which has created much uncertainty for private equity investors

The valuation adjustment mechanism (VAM), also known as the gambling agreement in China, is a commonly used tool for business investment, especially in growth enterprises. VAM is a set of contracts between investors and investees regulating their rights and obligations based on the uncertainty of the investees' future performance. It is an option embodied in binding contracts, which can protect the investor's interests. However, a recent case has quashed the possibility of realising the option previously agreed between the investor and investee, where the courts held that the contract carrying the option was void. This was the first time a Chinese court issued its opinion on the effectiveness of VAM and poses an unexpected question to private equity investors – is VAM still valid in China?

VAM is also known as the gambling agreement, but this has caused misunderstanding among investors and the courts

The case

Gansu Shiheng Nonferrous Resources Recycle is a wholly foreign-owned enterprise, fully owned by Hong Kong Diya. In 2007, by entering into an investment contract with Shiheng and Diya, Suzhou Industrial Park Haifu invested Rmb20 million ($3,148,745) into Shiheng and became the other shareholder of Shiheng, holding 3.85% of its equity interest. The VAM agreed upon by the parties is that if Shiheng's net profit in 2008 does not reach Rmb30 million ($4,723,139), Shiheng shall indemnify Haifu an amount equalling to Rmb20 million x (1- 2008 net profit/Rmb30 million) and Diya shall undertake supplementary liability of indemnity if Shiheng fails to fully indemnify Haifu.

Shiheng realised a profit of Rmb26,800 ($4,220) in 2008 and was then sued together with Diya by Haifu, requesting an indemnity of Rmb19,980,000 ($3,145,787), as agreed in the investment contract. The first instance court and the court of appeal heard the case. Both courts adjudicated that the VAM provided for in the investment contract was invalid, but on different grounds. The judgment delivered by the court of appeal is final and is under review by the Supreme People's Court.

Despite both the First Instance Court and the Court of Appeal basing their ruling on different grounds, they both invalidate the investment contract and make the VAM unenforceable

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The adjudication

The First Instance Court held the VAM void on the grounds that the investment contract was in violation of Article 8 of the *PRC Sino-foreign Equity Joint Venture Law* (中华人民共和国中外合资经营企业法). The Court held that by allowing the indemnity, the parties failed to distribute the net profit of Shiheng to its shareholders in proportion to their respective contributions to the registered capital. The Court also thought that the existence of the VAM jeopardised the interests of Shiheng and its creditors, violating Article 20 of the *PRC Company Law* (中华人民共和国公司法). The contract was therefore deemed invalid due to its violation of laws and the VAM payable not allowed.

The Court of Appeal ruled the VAM invalid on different grounds. The Court did not even define the Rmb20 million invested into Shiheng as investment. Rather, pursuant to Article 4(2) of the *Answers to Questions Regarding Trial of Cases about Economic Association Contract Cases* (关于审理联营合同纠纷案件若干问题的解答) from the Supreme People's Court (SPC), the Court of Appeal declared that most of the fund was a loan owed to Haifu because Haifu neither participated in Shiheng's operation nor assumed any risks. According

to the VAM, where the agreed profit target is not reached, Haifu may recall its principal and interest. For this consideration, the Court ruled that the contract violated relevant financial regulations, was invalid and Shiheng should be liable to pay back to Haifu Rmb18,850,000 ($2,968,096) with interest.

Justifying the rulings

Despite both the First Instance Court and the Court of Appeal basing their ruling on different grounds, they both invalidate the investment contract and make the VAM unenforceable. The First Instance Court's reasoning on profit distribution is doubtful since the VAM is not set for profit distribution and Haifu has never claimed distribution of profit. The Court also failed to clarify how the agreed indemnity can be considered profit distribution. Their other finding regarding the Company Law is not appropriate in this case, as the Law only applies where the shareholders abuse their rights to harm the company, or jeopardise the creditors' interests by abusing the company's status as an independent legal person and the shareholder's limited liabilities. Even if Shiheng suffers losses by indemnifying Haifu in accordance with the VAM, it is for the performance of the investment contract rather than the consequence of Haifu's abuse of its shareholder's right.

The ruling from the Appeal Court is also questionable. The legal basis for the ruling is the SPC's Answers. This is a judicial interpretation issued in 1990 regulating a specific type of business activity. The Answers are outdated and apparently not designed to regulate VAM. Even if the Answers are applicable to VAM, it is still problematic because of the contradictions.

Article 4(2) of the Answers stipulates that if an enterprise investing into an economic association neither participates in its operation nor assumes risks by way of recalling the principal and interest regardless of profit or loss, or gaining fixed profit as scheduled, the relation shall be deemed as a loan which violates relevant financial regulations and shall be held invalid. If the rulings were justified, the voided VAM should have always enabled Haifu to recall its principal and interest regardless of whether Shiheng made a profit, or gained fixed profit as scheduled.

However, this is not the case. It is true that Haifu is entitled to the indemnity when Shiheng's profit in 2008 is less than Rmb30 million. According to the investment contract, which seems to enable Haifu to recall its principal and interests when Shiheng fails to achieve expected profits, but when Shiheng's profit in 2008 exceeds Rmb30 million, Haifu is not entitled to the indemnity and cannot recall its principal and interest. Naturally Haifu cannot always recall its principal and interests, nor can it gain fixed profit as scheduled. An example clearly highlights this — if Shiheng's 2008 profit is Rmb29,999,999, the VAM will be held invalid by the court because Haifu is entitled to the indemnity, while when the profit is Rmb30,000,001, using the Appeal Court's logic, the VAM is valid since there will be no recall of principal and interest or fixed profit. It is hardly justifiable that the court's decision on the validity of VAM varies due to this insignificant profit change.

Dealing with risk

The direct consequence of the rulings is borne by the parties involved in the case. The First Instance Court dismissed every claim from Haifu after adjudicating that the VAM was invalid and awarded nothing to the investor. The Court of Appeal also adjudicated the VAM invalid but awarded to Haifu a sum of compensation since Haifu deserves to have the loan returned.

While China is not a case law country, this decision will send a message to other courts and affect judge's understanding of the VAM. Undoubtedly, this case will affected the outcome of future cases. As noted earlier, the case is before the SPC and the adjudication of the Appeal Court is final unless the SPC overrules it.

Interestingly, neither the First Instance Court nor the Court of Appeal evaluated the true value of Shiheng's equity interest at the time Haifu became its shareholder. This is understandable as the price paid by Haifu is set forth in the investment contract, which reflects the parties' true intention and autonomy. Haifu's total investment was Rmb20 million, 5% of which or Rmb1 million was contributed to Shiheng's registered capital and the remaining deposited into Shiheng's capital reserve. Haifu paid such a high premium for a reason – the VAM. It is unfair for the courts not to consider the high premium paid by Haifu when voiding the legal basis for Haifu to gain unfair indemnity.

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Both rulings held that the VAM is invalid because the investment contract violates the law. This may highlight a solution for PE investors to mitigate the risk of their VAM being held invalid when structuring new deals.

The bottom line for investors is that there are always risks. Once the investment is made, there is no guarantee whether the investment will be successful. This is especially true as investment contracts are voidable and thus cannot guarantee a return under Chinese law. The solution for investors may be to take the risk of the investment, but claim for a refund rather than a return of investment when suing.

Haifu and Shiheng could enter into a new investment agreement, which states that Haifu agrees to pay a total sum of Rmb20 million to Shiheng, 5% of which is contributed to Shiheng's registered capital as a price for the exchange of 3.85% equity interest of Shiheng. The remaining funds are deposited into Shiheng's capital reserve as a future price for the underestimated value of the equity interest on the condition of a net profit of Rmb30 million. The parties also agree that this future price becomes payable upon the achievement of the net profit, or refundable in case of lower profit, in either case the ownership of the 3.85% equity interest remains unchanged. Would this new investment contract be held void when Haifu claims the refund of the 95% of the Rmb20 million?

The answer is probably not. In the above arrangement, Haifu

has already paid Rmb1 million for the exchange of the 3.85% equity interest so it is the investment. The remaining funds still belong to Haifu even though it has been paid to Shiheng before it is turned into investment as agreed. It will only become an investment when the pre-set condition is satisfied. Otherwise it remains Haifu's money and the refund is legitimate and fair. This may be one of the many possibilities where a VAM be allowed to function properly. Nevertheless, it still depends on how the PRC Supreme People's Court rules over the case.

A repeatedly shared opinion is that the term VAM has been misrepresented in China. The result is that this common and necessary mechanism in investment and financing transactions is interpreted to have the meaning of gambling, which to some extent twists the relation between the investors and the management to opposing parties. The ruling of the first case concerning VAM in China further weakens the legal basis of VAM. The SPC's decision has the power to make or break the future of PE investors.

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