

# Analysis of the Review of the Performance of Equity Repurchase Under VAM Agreements

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## ABSTRACT

After the promulgation of the Minutes, the focus of controversy in equity repurchase VAM agreements has shifted from the legal effect of VAM agreements to the performance of VAM repurchases. At present, the main obstacle to VAM repurchase is the principle of capital maintenance and the restriction on equity repurchase, which makes it impossible for investors to exit through equity repurchase. After analysing the obstacles to the performance of VAM repurchases, it is proposed to adopt the solvency criterion to clarify the legally available funds. Clarifying the relationship between VAM repurchase and capital maintenance and opening up the restrictions on equity repurchase are the correct rule for reviewing equity repurchases.

## KEYWORDS

VAM; Share buybacks; Capital maintenance

## 1. INTRODUCTION

A VAM, also known as a valuation adjustment agreement, refers to the allocation of risks to the valuation of a company made by the investor and the target company for the purpose of financing uncertainties such as the growth of the company's performance in the future. Due to its financing attributes, VAM agreements have been widely used in practice, but they are also full of disputes, and the validity of VAM agreements and the performance of VAM agreements have been debated endlessly in academic and practical circles.

In 2019, the first paragraph of Article 5 of the Minutes clarified the legal effect of the VAM between the investor and the target company, and confirmed that the VAM principle was valid. At the same time, based on the intent of protecting the interests of the creditors of the target company, corresponding restrictions are imposed on the enforceability of the VAM (i.e., whether the investor can claim actual performance), realising the transformation of the core of the adjudication from the legality of the transaction type to the possibility of contract performance [1]. Judging from the results, the promulgation of the minutes has resolved the controversy over the legal validity of VAM agreements, but the issue of the performance of VAM agreements has brought about an unavoidable reality. Based on this, in the second paragraph of Article 5 of the Minutes, the review criteria for the possibility of VAM equity repurchase are reviewed, i.e., if the shareholder shall not withdraw capital contributions and the mandatory provisions of the equity repurchase restrictions in the Company Law, and the capital reduction procedure is not completed, the investor's claim for actual performance will be dismissed.

However, the above-mentioned review rules for VAM equity repurchase do not conform to the rationality of commercial practice, and directly incorporate the conditions for VAM equity repurchase into the company's capital reduction, so that the capital reduction procedure is tied to the equity

repurchase. From the perspective of the legal system, China's equity repurchase system itself is flawed, strictly abiding by the principle of capital maintenance, mechanically using the principle of capital maintenance to protect the interests of creditors, and mistakenly believing that the repurchase behaviour damages the principle of capital maintenance. Secondly, from a practical point of view, taking the company's capital reduction procedure as a prerequisite for equity repurchase makes the investor's rights and interests determined by the target company's capital reduction resolution, which is also prone to business ethics hazard. Therefore, it is necessary to properly establish the review rules for VAM share repurchases. This paper will analyse and demonstrate the current obstacles to the performance of VAM equity repurchases, analyse the reasons for the performance obstacles from the source, and propose countermeasures based on this, and improve the review rules for the possibility of equity repurchase performance by clarifying the solvency of equity repurchases and opening up equity repurchases.

## **2. OBSTACLES TO THE PERFORMANCE OF EQUITY REPURCHASE UNDER VAM AGREEMENTS**

### **2.1. Obstacles to Performance Based on the Principle of Capital Maintenance**

The principle of capital maintenance is the basic principle of the company's capital system, and its main content is to require the true and effective capital of the company, and the company's assets should be kept consistent with its registered capital on a regular basis during the company's existence, and the company's net assets should be avoided as much as possible to avoid the deficit of the company's net assets lower than the company's registered capital [2]. The most direct manifestation of the capital maintenance principle is the company's earnings distribution rules and equity repurchase rules, but their essence is to prohibit the company's property from flowing into shareholders free of charge or at a low price, resulting in the loss of the company's net assets, thereby harming the interests of creditors. From the perspective of creditor protection, it is necessary to deny the company's equity repurchase obligation under the VAM based on the principle of capital maintenance, because from the perspective of company law, when the company buys back the equity, it means that the company has paid the property to the shareholders without consideration. But the best way to protect the interests of creditors should be the healthy operation of the company, rather than the mechanical application of the principle of capital maintenance. Only when the company develops well, its corporate assets will continue to grow, rather than sticking to the original static assets, so as to fundamentally ensure the rights and interests of relevant stakeholders.

The main reason for hindering the performance of VAM equity repurchase based on the principle of capital maintenance is that the equity repurchase will damage the company's capital adequacy, and it is erroneously believed that the equity repurchase itself violates the principle of capital maintenance and damages the company's capital. As a result, the Company Law does not base itself on the "fact" of destroying capital, but on the premise of the "possibility" of destroying the maintenance of capital [3]. On the grounds of the protection of creditors, all acts that may violate the principle of capital maintenance and harm the interests of creditors are directly and infinitely prohibited; Such an act can certainly protect the interests of creditors, but it also stifles the protection of other stakeholders. The investor of the VAM agreement provides funds to help the company raise funds based on the development of the company's future performance, so as to obtain the equity of the target company, and requires an exit through equity repurchase because the final company's performance does not reach the ideal state, which is a high degree of consensus between the investor and the target company on market transactions. At this stage, it is reasonable to adopt the principle of capital maintenance in the Company Law to restrict the performance of the equity repurchase of VAM agreements, and to use the mandatory norms of the Company Law to restrict the performance of the contract. Specifically, the shares held by the investor under the share repurchase VAM are similar to preferred shares with the dual attributes of equity and debt [5]. Therefore, it is necessary to apply the mandatory rules of

the Company Law to review VAM equity repurchases, but it is also necessary to face up to the characteristics of VAM equity repurchases, rather than uniformly applying the Company Law to regulate the equity held by investors.

## **2.2. Obstacles to Performance Based on Restrictions on Equity Repurchases**

China's "Company Law" has always adhered to the basic principle of "prohibiting in principle and allowing exceptions" for equity repurchase, and there are six situations in which equity repurchase is allowed by exception. However, from a practical point of view, the six forms of equity repurchase currently stipulated in China's Company Law do not meet the market demand. The equity repurchase under the VAM agreement cannot be included in any of the provisions of the Company Law of the People's Republic of China on the circumstances of equity repurchase, so that at the beginning, in judicial practice, the VAM repurchase directly violated the equity repurchase restriction clause of the Company Law, thereby negating the validity of the VAM equity repurchase. Although the minutes directly stipulate that if the capital reduction procedure is not completed, the investor's claim for the actual performance of the equity repurchase shall be rejected; From a formal point of view, this provision includes the special circumstance of VAM equity repurchase into the capital reduction repurchase, which is really a helpless move.

The minutes stipulate that the capital reduction procedure and the VAM repurchase are bound, making the target company's failure to complete the capital reduction procedure an obstacle to the performance of the VAM equity repurchase, which will create a conflict between the VAM repurchase and the normal equity repurchase procedure under the Company Law. The normal equity repurchase procedure should be to repurchase the equity first before the capital reduction procedure can be completed; Because once the capital reduction procedure is completed, it means that the investor has traded the equity with the company, and the company has reduced the registered capital and completed the equity cancellation. However, the minutes require that the capital reduction procedure be completed first, and the equity repurchase required by the investor can only be actually performed; There is a legal disconnect between this and the statutory capital reduction procedure set out in the Companies Act.

Of course, some scholars have different understandings of the pre-emptive capital reduction procedures in the Minutes, believing that the capital reduction procedure does not mean that it is necessary to complete the capital reduction change in registration, but requires the company to make an effective resolution on capital reduction. Although this understanding can eliminate the misunderstanding of the pre-emptive capital reduction procedure, it also raises a new problem, that is, the business ethics hazard of the target company. The equity repurchase requested by the investor is entirely dependent on the capital reduction resolution made by the target company, which puts the legitimate rights and interests of the investor in an uncertain state, and the rights and interests of the investor cannot be protected, which is essentially a denial of the application of the VAM.

## **2.3. Summary of Obstacles to Performance**

Through the analysis of the obstacles to the performance of equity repurchase, it can be concluded that there are corresponding practical problems in the performance obstacles based on the principle of capital maintenance or the restriction of equity repurchase. As the basic principle of a company, the principle of capital maintenance can certainly protect the interests of creditors, but there are also infinite expansion of the interests of creditors, and most of these interests are unproven, ignoring the interests of investors. The restriction on equity repurchase, especially the capital reduction procedure as a precondition for equity repurchase, is a helpless move, and it is also easy to cause business ethics hazard, and the referee cannot force the company to perform the capital reduction procedure, so that the VAM repurchase is seriously constrained. Therefore, there is a need for new review standards for the actual performance of share buybacks, rather than sticking to existing imperfect rules.

### **3. THE SOLVENCY OF VAM REPURCHASES**

The core dispute over the obstruction of VAM equity repurchase based on the principle of capital maintenance is whether the equity repurchase will damage the company's capital and the company's solvency.

#### **3.1. Determine the Solvency Criteria**

China's current principle of capital maintenance is similar to the traditional authorised capital rule of U.S. corporate law, that is, it prohibits companies from repurchasing equity under the condition of weakening the company's capital. However, unlike the restrictions on the funds for equity repurchase in the traditional authorised capital rules in the United States, China's Company Law does not clearly stipulate the funds for equity repurchase. Therefore, there are currently two ways to repurchase equity in China, one is to adhere to the principle of capital maintenance and systematic interpretation, the funds for equity repurchase should also be the company's surplus assets, and the capital reduction procedure can be adopted when the funds are insufficient; The second is to adopt the solvency standard, and not use the company's surplus assets as the only source of funds for equity repurchase. Both methods have their own advantages and disadvantages, and there is no consensus in China's practical circles at present.

As analysed above, there are shortcomings in the current use of capital reduction procedures as a precondition for equity repurchases, and sticking to the principle of capital maintenance is not the best solution to protect the interests of creditors. The Delaware court in the United States has also clarified that the "legally available funds" limit not only refers to the authorised capital or surplus limit under statutory law, but also includes the solvency limit of other statutory law and case law, that is, the dual judicial review of the application of "insolvency" under the balance sheet and "solvency" under the bankruptcy law is emphasised [4]. On the basis of learning from the judicial practice of the United States, China's VAM repurchase should adopt the solvency standard, break through the capital surplus of the company's account books, and use all the company's funds to fulfil the repurchase obligation as much as possible.

#### **3.2. Clarify the Lawful and Available Funds**

On the premise that the premise of VAM repurchase should be that the company has solvency, we need to clarify the funds that can be used to repurchase equity. The VAM repurchase obligation is essentially a monetary payment debt, because the target company obtains the company's equity by paying consideration to the investor, and the possibility of performing the VAM repurchase is the source of the repurchase funds, and the target company can use the funds to perform the repurchase obligation without harming the interests of its creditors [1]. This kind of money used to repurchase the equity under the VAM is also known as legally available funds.

When determining legally available funds, the first step is to assess the true value of the company's assets, not the company's accounting book data. It is true that the company's accounting books reflect the economic status of the company's operations, but the data recorded in the company's account books are historical data, which can only reflect the economic value of the company, and cannot reflect the appreciation of the company's assets. Finally, when determining the legal available funds of the company, the principle of commercial judgment should be adopted, and only by applying commercial judgment can the available funds of the company be judged in the most rational manner. For example, the Thought Works case in the United States also incorporated the operation of the authorized capital rule in the context of preferred shares into the business judgment of the board of directors, relying on the decision-making of the board of directors and providing the protection of the business judgment rule when determining whether the company has a surplus and solvency [4]. We can also draw on the relevant business judgment experience, rely on the business judgment of the

company's board of directors, and have the court review it to more accurately determine the funds that the company can use to perform the VAM repurchase.

## **4. RESTRICTIONS ON VAM REPURCHASES ARE RELAXED**

The second obstacle to the performance of VAM repurchase is the restriction of equity repurchase in China's Company Law, and the equity repurchase system determines the possibility of actual performance of VAM repurchase.

### **4.1. Clarify the Relationship Between Capital Maintenance and Equity Repurchase**

The principle of capital maintenance does not explicitly appear in the provisions of China's company law, but is reflected in fragmented clauses, and the equity repurchase restriction clause is the embodiment of the principle of capital maintenance in China's company law. We must recognise that the company law is nothing more than a set of mechanisms for coordinating the interests of all parties, and overemphasising the independence of the company's personality or assets while ignoring the real interests behind it is precisely what legislation and judicial decisions should strive to avoid [5]. We need to pay attention to the capital adequacy of the company emphasised in the principle of capital maintenance, but we should also express the true intention of the investor and the target company on equity repurchase in the VAM agreement. Both parties to the VAM are market economy entities and have commercial rationality, and since the equity repurchase agreed in the VAM agreement must also reflect their true interests, it is not appropriate to simply apply the mandatory regulations of the Company Law to erase the true intentions of the parties.

Second, as mentioned in the above analysis, a simple share repurchase does not necessarily damage the company's capital, resulting in a loss of the company's net assets. Therefore, when considering equity repurchase, only when the equity repurchase actually damages the company's capital, should it be a violation of the capital maintenance principle. In particular, when the company has legally available funds to repurchase shares, it is even more inappropriate for us to prohibit equity repurchase under the pretext of the principle of capital maintenance.

### **4.2. Restrictions on Equity Repurchase are Relaxed**

The provisions of the Company Law of the People's Republic of China on the restrictions on equity repurchase are limited to the six situations stipulated in it, and the listed matters do not fail to meet the development requirements of China's equity repurchase situations at this stage. The regulatory model of enumerating the statutory reasons for repurchase makes it easy for adjudicators to form path dependence and ignore the core element of corporate allocation bottom line regulation, such as the principle of capital maintenance, which is corporate finance [6]. In summary, the current restrictions on equity repurchase in China do not meet the requirements of the company's adjustment of share capital structure at this stage, and seriously restrict the equity repurchase behaviour in practice.

In order to protect the solvency of the company, the company's repurchase must not damage the capital. However, the value of "capital" to protect creditors is not to use "capital" to repay debts or provide security for creditors' rights, but that the company can use capital to absorb losses, cope with risks, and avoid damage to the interests of creditors [7]. Therefore, the restriction on the repurchase of the company's shares should not be prohibited on the grounds of capital maintenance, but only the source of funds for the repurchase needs to be restricted. Finally, the opening of the equity repurchase system meets the requirements of the development of economic globalisation. With the continuous opening up of China's capital market, it has become commonplace for foreign investment institutions to engage in VAM with Chinese companies, and China's policies and legal systems, especially the company law system, should conform to international development.

Drawing on the liberalisation of equity repurchase regulations in foreign countries, China can add special circumstances that can repurchase equity to the equity repurchase restrictions stipulated in the Company Law. "Openness" is also the pursuit of China's equity repurchase system, and its specific manifestation is the special situation of increasing the repurchase of equity [3]. In addition to this limited opening method, it is also possible to directly open up the full opening of equity repurchases. That is, on the basis of respecting the principle of capital maintenance, there is no restriction on the circumstances of equity repurchase, but it is necessary to clarify the financial resource limit for equity repurchase. Under the limitation of financial resources, the part of the funds available for equity repurchase of the company includes surplus reserve funds and undistributed profits, which will not damage the company's capital.

## 5. SUMMARY

In the performance of VAM equity repurchase, the principle of maintaining the company's capital is only a constraint on the possibility of performing the repurchase obligation, but it should never become a prohibited condition for the performance of the repurchase. On the basis of respecting the principle of capital maintenance of the company, the equity repurchase obligation of the VAM agreement should be fulfilled to the greatest extent possible. At present, the rules for reviewing the possibility of performance of VAM repurchase should not be based solely on the equity repurchase provisions of the Company Law, but should be combined with the real interest relationship in the VAM agreement, as long as the funds used to repurchase the equity do not harm the company's capital, the equity repurchase should be performed. There are obvious legal loopholes in the provisions on the performance of VAM repurchases in the minutes, and we should understand the basic principles of restricting the performance of VAM repurchases, and clarify the scope of application of the restrictions, so as to accurately balance the interests of investors, target companies and creditors.

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