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CONTRACTUAL INNOVATION IN CHINA’S VENTURE CAPITAL MARKET

Lin Lin*

European Business Organizational Law Review (forthcoming, 2020)

Abstract

There is little empirical work examining contractual innovation in the context of China, which is the second largest venture capital market in the world, after the United States. Drawing upon extensive interviews, a hand-collected dataset of investment agreements and judgements made by Chinese courts on venture capital disputes, this article examines a unique contractual design that is common in the Chinese venture capital sector—the valuation adjustment mechanism (“VAM”). A VAM provides investors with a right to adjust a portfolio company’s original valuation and to get compensation by cash or equity upon the occurrence of certain future events (such as failing to meet financial or non-financial performance indicators). The prevalence of VAMs in China is potentially attributable to: (1) severe information asymmetry in the less informed market, (2) the lack of convertible preferred stock under Chinese law and excessive legal restrictions over investment tools and contractual mechanisms in venture capital financing, and (3) insufficient legal protection for investors under Chinese law. This article argues that, unlike American venture capital contracts, which are designed to encourage long-term, sustainable investor-entrepreneur relationships, VAMs are predominantly investors’ self-help mechanisms to address specific and serious investor protection issues in the transitional and less informed Chinese market. Thus, it suggests that the problems regarding investor protection motivating the use of VAMs can be better

* Assistant Professor, Faculty of Law, National University of Singapore (NUS). I thank the interviewees from the United States, China and Singapore, who have generously shared their knowledge and insights with me. They are the venture capital attorneys, venture capitalists, entrepreneurs, fund managers, individual investors and representatives of institutional investors who were willing to answer my questions and, in some cases, provide the investment agreements that are the focus of this Article. I am extremely grateful to Sir Robin Saxby at ARM Holdings, Alex van Someren at Amadeus Capital, Zhang Ping at Han Kun Law Offices, Ma Lingjun at Fangda Partners and Zou Jing at Guohao Law Firm. I thank the participants in the Chicago-Tsinghua Junior Faculty Forum, Oxford Commercial Law Centre Lecture Series, and the symposium of “Alternative Investments in the Tech Era” for their valuable comments to this paper. I am grateful to Luca Enriques, Michael Klausner, William Hubbard, Kristin van Zwieten, Zhang Wei, Zhu Jinwen and Jerrold Soh for valuable comments to early drafts of this paper. All errors remain my own. The research is supported by the Singapore Ministry of Education Academic Research Fund Tier 1 (WBS No.R241000155115).

solved by law reforms such as allowing limited liability companies to issue convertible preferred stock, introducing more legal remedies for minority investors, as well as an improved regulatory environment governing venture financing.

1. Introduction

Venture capital, apart from being a powerful engine that can drive a nation's innovation and macroeconomic growth,¹ is also fertile ground for extensive contractual innovation. This article focuses on the Venture Capital Fund-Portfolio Company Contract concluded between venture capital funds and portfolio companies at the investment stage. Specifically, it finds a unique contractual design in the Chinese venture capital sector—the valuation adjustment mechanism (“VAM”). A VAM (also termed as a “bet-on agreement”, pinyin: *duidu xieyi*) is concluded between the venture capital funds and the portfolio company or its shareholders and identifies conditions which confer the investors a contractual right to adjust the portfolio company's valuation or to get compensation from the company or its shareholders.² These conditions may include financial (such as revenue and profits) or non-financial performance indicators (such as product sales, launching a product and getting a patent), as well as the occurrence or non-occurrence of specified events such as an Initial Public Offerings (“IPO”) or Merger and Acquisition (“M&A”). If the specified conditions are met, the main mechanisms through which investors then adjust the company's valuation or get compensation include, for example, compensation by cash or a transfer of equity to the investors at little or no cost. Although VAMs are prevalent in the Chinese market,³ they are not commonly found in their American, British, Singaporean and Indian counterparts based on my empirical studies.⁴ This article thus seeks to

¹ Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003). On the importance of VC, see generally Marco Da Rin et al., *The Law and Finance of Venture Capital Financing in Europe: Findings from the RICAFE Research Project*, 7 EUR. BUS. ORG. L. REV. 525 (2006).

² See *Validity of Valuation Adjustment Mechanism*, LehmanLaw, <http://www.lehmanlaw.com/resource-centre/faqs/financial-services-and-regulation/validity-of-valuation-adjustment-mechanism-vam-agreement.html> last visited July 3, 2019.

³ 20 out of 40 hand-collected investment agreements contain VAMs. (On file with author)

⁴ National Venture Capital Association (NVCA) Model Legal Documents, NVCA, <https://nvca.org/resources/model-legal-documents/> last visited July 3, 2019. The NVCA agreements, developed by US industry practitioners, intend to reflect current practices in the US venture capital industry with a fair representation of both East Coast and West Coast practices and a relatively mutual position between venture capitalists and portfolio companies. These include, inter alia, term sheet, certificate of incorporation, stock purchase agreement, voting agreement, investor rights agreement and right of first refusal and co-sale agreement. Silicon Valley Venture Capital Survey, Fenwick & West LLP (2019), <https://www.fenwick.com/topics/pages/topicsdetail.aspx?topicname=vc%20survey> last visited 3 July 2019, Cooley's Series Seed Equity Financing Package, Cooley Go (2017), <https://www.cooleygo.com/documents/series-seed-equity-financing-package/> last visited July 3, 2019, the SAFE (simple agreement for future equity), <https://www.ycombinator.com/documents/> last visited July 3,

answer three fundamental questions: *first, what is the economic function of VAM? Second, why are VAMs only prevalent in the Chinese market? Third, are VAMs a desirable contractual innovation and under what conditions might VAMs be useful transplants into other jurisdictions?*

The legal literature relating to contractual innovation in venture capital has largely been compiled in the American context. Existing scholarship has generally dealt with the various methods through which venture capital contracts address the agency problems inherent in the venture capital cycle and the specific contractual terms invented to that end in the United States (“US”).⁵ In contrast, contractual innovation in China’s venture capital market has attracted scant attention in the legal literature to date, making it difficult for practitioners and academics alike to better comprehend and theorise the making of contracts.⁶

This article fills the literature gap by using hand-collected qualitative and quantitative data. The first part of the dataset consists of 40 hand-collected Chinese-based investment agreements concluded between 2017 to 2019.⁷ The second part comprises interviews with 80 key market participants, including lawyers, venture capitalists, founders of startups and large technology or e-commerce companies, individual investors and representatives of institutional investors.⁸ The

2019, and CARE (convertible agreement regarding equity), <https://www.svca.org.sg/publications/vima-kit> last visited July 3, 2019, do not mention VAMs or equivalents. I also interviewed a number of American attorneys, British venture capitalists, Singaporean lawyers and Indian lawyers and they also mentioned that they never used VAM in their venture capital deals. These interviews include an interview with the managing partner of Amadeus Capital Partners, Mr. Alex van Someren on 15 November 2019, an interview with the general counsel of Temasek Holding on May 30, 2019 in Singapore, an interview with two partners of WongPartnership LLP on May 30, 2019 in Singapore, an interview with two partners of Clifford Chance on July 5, 2019, an interview with a former partner of Amarchand & Mangaldas & Suresh A Shroff & Co (India) on June 6, 2019. The Indian lawyer mentioned that although VAM is uncommon in India, it is common for Indian investors to use a VAM-like put option in VC deals, i.e. investors have the option to sell shares at an agreed price if the investee company does not meet the set performance target). The Singaporean lawyers mentioned that investors in Singapore do not use VAM but they use convertible preferred stock very often. Moreover, a search for “valuation adjustment” or “price adjustment” with “venture capital” or “private equity” in Lexis and WestLaw yields no result insofar as American and commonwealth jurisprudence is concerned.

⁵ Kate Litvak, Monte Carlo Simulation of Contractual Provisions: An Application to Default Provisions in Venture Capital Limited Partnership Agreements 98 CORNELL L. REV. 1495 (2013). Kate Litvak, Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements 76 U. CHI. L. REV. 161 (2009).

⁶ There is some literature on VAM, written in Chinese. See Liu Yan, VAM and Capital Management under Company Law (2016) 3 Global Law Review 137-156; Zhang Wei, “No VAM in Silicon Valley” in Law of Capital (Law Press China, 2017), pp 4-6.

⁷ These agreements are obtained from Chinese law firms and venture capital firms, including, inter alia, Gaorong Capital, Shiyue Hualong Management Limited Partnership, Jieyi Capital, Hankun Law Offices (Beijing office and Shanghai office), Fangda Partners (Shanghai office), King & Wood Mallesons (Shanghai office, Guangzhou office and Shenzhen office), Zhonglun Law Firm (Shanghai office and Shenzhen office), Guohao Law Firm (Shanghai office), Deheng Law Firm (Shenzhen Office), Global Law Office (Beijing Office), Huashang Law Firm (Shenzhen office), Tongli Law Firm (Shanghai office), Jintiancheng Law Firm (Shanghai office), Qiheng Law Firm (Shanghai office), Guangfa Law Firm (Shanghai office), Tiance Law Firm (Shanghai office). These agreements only include the agreements between Chinese parties and exclude agreements that involved foreign parties.

⁸ Interviewees consist of: (1) partners, analysts and legal counsels from venture capital or private equity firms: Amadeus Capital Partners (UK), Temasek Holding, Gaorong Capital, Chengwei Capital, Shenzhen Cedar Fund Management Company, Jieyi Capital,

third part consists of 253 judgements obtained from the database maintained by the Chinese courts on disputes relating to VAM in venture capital investments from 2012-2019.⁹ The fourth part comprises a study of a wide range of data and reports published by leading law firms and service providers in China and the US.¹⁰ The fifth part comprises a study of model contractual agreements used in American venture capital market.¹¹

Tapping on the empirical data, this paper concludes that VAMs function as contractual protection to investors. A VAM is adopted to bridge the valuation gap and reduce overvaluation risks for investors and provide incentives for entrepreneurs to perform. An alternative and popular mechanism used in the US is convertible preferred stock. However, Chinese companies, including both limited liability companies and joint stock companies are not allowed to issue convertible

Songhe Yuanwang Capital, Shengda Group, Shiyue Hualong Management Limited Partnership, Island Peak Innovation, Shenzhen Hualin Securities, Shenzhen Jiangyi Venture Capital Limited Partnership, Bondbridge Asset Management Company, Hainan Development Investment Holdings Co., Ltd, China Investments Corporation (Shenzhen office) and Citic Investments, iGlobe Partners (Singapore), Jieyi Capital and Tembusu Partners (Singapore); (2) partners and associates from law firms: Orrick, Herrington & Sutcliffe LLP (Shanghai office), Clifford Chance (Singapore office), Allen & Gledhill LLP (Singapore office), WongPartnership LLP (Singapore office), Hankun Law Offices (Beijing office and Shanghai office), JunHe LLP (Shenzhen office), Fangda Partners (Shanghai office), King & Wood Mallesons (Shanghai, Shenzhen and Hong Kong offices), Zhonglun Law Firm (Beijing, Shanghai and Shenzhen offices), Grandall Law Firm (Shanghai office), Deheng Law Firm (Shenzhen Office), Global Law Office (Beijing office), Allbright Law Office (Shanghai office), Grandall Law Firm (Shanghai office), Broadbright Law Firm (Beijing office), Huashang Law Firm (Shenzhen office), Tongli Law Firm (Shanghai office), Jintiancheng Law Firm (Shanghai office), Qiheng Law Firm (Shanghai office), Guangfa Law Firm (Shanghai office), Tiance Law Firm (Shanghai office), Broad and Bright Law Firm (Beijing office), Tianjin Guantao Law Firm, Yingke Law Firm (Guangzhou office), Guangzhou Zhuoxin Law Firm, Chongqing Zhonghao Law Firm and Shanghai Yiniming Law Firm; (3) founders and entrepreneurs from start-ups or large technology or e-commerce companies: CTO of Qunar.com, CEO of the CXA Group (Singapore office), founders of Yincubator, Founder and CEO of ZBMY, Founder and CEO of SILOT and manager of Shenzhen United Property and Share Rights Exchange; (4) legal counsels and managers of institutional investors: Sichuan Development Investment Holdings Co., Ltd., Zhangjiang Hi-Tech Park and Hainan State Farms Group. Most of the practitioners are based in Beijing, Shanghai, Tianjin, Shenzhen, Chongqing and Guangzhou, which are the major venture capital hubs in China. I also interviewed practitioners based in Singapore, Hong Kong and Silicon Valley; (5) drafters of the VIMA (Venture Capital Investment Model Agreements); and (5) regulators from Asset Management Association of China (AMAC).

⁹ These judgements were obtained from the database maintained by the Chinese courts available at China Judgements Online, <http://wenshu.court.gov.cn> last visited 4 Oct 2019 and were issued between 7 November 2012 and 4 October 2019, inclusive. 1072 results were obtained by using the search term “VAM agreement” (“对赌协议”). Each judgement was read to ascertain the factual context and the reasoning of the court so as to identify the cases which involved the use of VAM in the context of a private equity or venture capital investment. Of the 1072 results obtained, 253 judgements involved the use of VAM agreements. This article is based on the results of these 253 judgements. Although there are a large number of arbitrations on VAMs, they are not accessible by the public as arbitral awards are confidential by nature. Such a comprehensive—both qualitatively and quantitatively—dataset, with a particular focus on court judgments, was collected so as to eliminate potential selection bias in the hand-collected agreements and interviews.

¹⁰ These reports include: (1) the Annual Report of the Venture Capital Market in China published by the Zero2IPO Research Center, (2) the China Venture Capital Yearbook published by China Venture Capital Research Institution, (3) the annual reports on venture capital published by the VentureChina.cn, (4) Han Kun’s Data Analysis Report for VC/PE Deals, HanKunLaw (2017), <https://hankunlaw.com/downloadfile/newsAndInsights/9be8ff02c61f5dcf3d49da6711bffe9.pdf> last visited July 3, 2019; and (5) Silicon Valley Venture Capital Survey, Fenwick & West LLP (2019), supra note 4.

¹¹ These model legal documents include the model legal documents made by the NVCA, the leading Silicon Valley law firm, Cooley LLP, supra note 4.

preferred stock under the Company Law of People’s Republic of China (“PRC Company Law”).¹² The paper suggests that the creation and prevalence of VAM in China is potentially attributable to: (1) severe information asymmetry in the less informed Chinese market, (2) lack of convertible preferred stock, and excessive legal restrictions over investment tools and contractual mechanisms in venture financing, and (3) insufficient legal protection for investors under Chinese law.¹³

In sum, this article develops a narrative of market participants creating self-help mechanisms through private ordering amidst a chaotic market with inadequate legal protection. Unlike the American venture capital contracts, which are designed to possess universal and long-term applicability,¹⁴ VAMs answer specifically to the investor protection issues in the transitional and less informed Chinese market. However, such contractual innovation is unhealthy for the long-term development of party dynamics in the venture capital market. It is not a desirable contractual innovation that can be transplanted to other jurisdictions either. Moreover, there are severe problems in using VAMs, such as unrealistic performance goals that reduce mutual trust between the parties, the lack of continuity and further motivation for entrepreneurs post-VAM, the complexity and high transaction cost of structuring a VAM, as well as legal uncertainties relating to the validity of VAMs.¹⁵

This article also contributes to the literature on the evolution of contracts by arguing that, unlike the US where lawyers play an outsized role in driving the process of contractual innovation,¹⁶ contractual protections, such as VAMs can also be highly influenced by investors who are seeking to protect themselves. More specifically, it is suggested that Chinese investors are actively seeking

¹² The reason for the lack of convertible preferred shares in China can be attributed to the restrictions in PRC Company Law which provides the general principle of “one share one vote” (see, for example, Article 103 of the PRC Company Law). My interview with a consultant of the PRC Company Law Reform experts committee on April 20, 2019 also indicated that regulators (especially the company registrars) lack capacity and willingness to administer companies with convertible preferred shares.

¹³ The gaps in investor protection are due to: (a) the lack of an effective statutory derivative action, (b) the lack of comprehensive fiduciary duties on directors, (c) the lack of a common law oppression mechanism, and (d) the lack of fiduciary duties on controlling shareholders or its equivalents. See text accompanying note 79 in this article.

¹⁴ Gilson, *supra* note 1.

¹⁵ See Part 2 of this article on the fact that VAM concluded between the portfolio company and the investors may be considered invalid by Chinese courts.

¹⁶ John F. Coyle and Joseph M. Green, *Contractual Innovation in Venture Capital* 66 *Hastings L. J.* 33 (2014); Stephen J. Choi et al., *The Dynamics of Contract Evolution*, 88 *N.Y.U. L. Rev.* 1 (2013) (discussing theories of contractual innovation).

out for protective measures and promulgating such norms instead of relying on the expertise of lawyers to do so on their behalf,¹⁷ for reasons that will be explained below.

This article suggests that the problems regarding investor protection motivating the use of VAMs can be better solved by: (1) removing legal obstacles in issuing investment tools by Chinese companies and allowing the issue of convertible preferred stock, and (2) improving the regulatory environment to provide better investor protection. These measures would enable parties to freely adopt established contractual instruments widely recognised in international practise and facilitate healthy and sustainable development of the market.

When providing analysis on the terms in the context of Chinese venture capital market, references will be made to US practice given that the US is the biggest and most established venture capital market in the world.¹⁸ As the boundary between private equity and venture capital is blurred in China,¹⁹ the discussion in this article covers both private equity and venture capital in China.

This article proceeds as follows. The second part examines the economic function of VAM and the reasons behind its prevalence in China. It also discusses the problems in using VAMs. The third part evaluates whether the VAM is a desirable contractual innovation and suggests the ways forward. The last part concludes.

2. Valuation Adjustment Mechanism

2.1.The Concept and Its Prevalence in China

A VAM is a contractual arrangement concluded between an investor (typically the venture capital fund) and a portfolio company's shareholders (typically the largest shareholder, founder or actual controller²⁰). The parties agree upon some conditions (future financial or non-financial performance indicator of the portfolio company) following which the investor may exercise a

¹⁷ See also, Lin Lin, [The Private Equity Limited Partnership in China: A Critical Evaluation of Active Limited Partners](#)" (2013) 13(1) Journal of Corporate Law Studies pp185 -217 (discussing LP activism in China).

¹⁸ Lin Lin, Engineering a Venture Capital Market: Lessons from China, 30(1) COLUMBIA J OF ASIAN LAW 160,162 (2017).

¹⁹ Id.

²⁰ PRC Company Law has recognised the concept of an "actual controller" in its 2005 amendments, which refers to anyone who is not a shareholder but is able to hold actual control of the acts of the company by means of investment relations, agreements or any other arrangements under Part 3 of Article 216.

contractual right to adjust the valuation of the company at little or no cost to investors.²¹ The specific terms of the VAM agreements vary widely across different companies and industries.²²

In essence, VAMs envisage future adjustments to the portfolio company's valuation through instituting forward-looking mechanisms to alter the relative shareholding or financial positions of entrepreneurs vis-à-vis investors upon the fulfilment of certain conditions or targets. The performance or "bet-on" targets generally fall within three common categories: (1) financial KPI (such as: revenue, EBITDA,²³ profits, sales growth rate, CAGR,²⁴ NAV,²⁵ turnover volume, market share); (2) non-financial KPI (quality of product, acquisition of new patents, successful industrialisation of new technologies or skills/processes; completion of a new strategic alliance; resignation rate of technical staff); (3) the occurrence or non-occurrence of specified events, which can correlate with the portfolio company's performance to different extents, such as Mergers & Acquisitions ("M&A") and Initial Public Offerings ("IPO"). The choice of the "bet-on" target may depend on the particular stage at which investment is coming in; early-stage investors may be more concerned with the delivery of a workable product and profit margins, whereas late-stage investors may focus more on IPO timelines. A workable framework to categorize such variations is presented in Table 1 and Diagram 2 as follows.

The data set of investigated judicial disputes suggest that the "bet-on" target in most of the VAM agreements relate to the listing of the portfolio company and the performance of the invested company. 65 out of 253 cases used IPOs and 65 out of 253 cases used performance goals as their targets. The popularity of IPO as the primary means of venture capital exit in China may explain the reasons why IPO is the most popular bet-on target for investors.²⁶ These events are not mutually exclusive and many VAMs subject the portfolio company to both targets (see Diagram 2). In addition to IPO and financial performance, there are 16 other types of "bet-on" targets, such

²¹ See Validity of Valuation Adjustment Mechanism, LehmanLaw, supra note 2.

²² For further discussion on VAM, see also YONG KWEEK PING, PRIVATE EQUITY IN CHINA – CHALLENGES AND OPPORTUNITIES, (John Wiley & Sons, 2012), at 114.

²³ Earnings before interest, tax, depreciation and amortization.

²⁴ Compound annual growth rate.

²⁵ Net asset value.

²⁶ The reasons why IPO is the most popular exit for venture capital investments in China has been explained in Lin Lin, "Venture Capital Exits and the Structure of Stock Markets: Lessons from China" (2017) 12(1) Asian Journal of Comparative Law 1 (These reasons include: (1) IPO-exits in China tend to give high returns, (2) M&As are less feasible as regulatory approvals are required for M&A transactions, and (3) stringent control over debt financing).

as the portfolio company's corporate management standards,²⁷ corporate structure²⁸ and the presence of related party transactions.²⁹

Further, if the targets are not met, four main outcomes could be envisaged by the contracting parties to “adjust the company's valuation”, as illustrated in Table 2 and Diagram 3 below: (1) compensation to investors by equity; (2) compensation to investors by cash; (3) redemption of shares (the portfolio company or its shareholders will redeem all or part of the shares held by the investor at an agreed price), or (4) increase in board representation for investors. At the same time, benefits to the company and management may be offered by the investor should the targets be met.

Among the hand-collected agreements, compensation by cash seems the most popular, being provided for in 15 of these agreements.³⁰ Diagram 1 (below) illustrates the calculation formula for cash and equity compensation. An illustration of this scenario can be found in one of the private agreements,³¹ where the portfolio company, the investor and an existing shareholder agree that if the company's after-tax profits in a specified year are lower than a stipulated amount, the investor has the right to choose between (1) cash compensation jointly and severally payable by the company and the shareholder (calculated by a formula that yields at least 115% of the investment amount) and (2) transfer of equity stakes (calculated by a stipulated formula as shown in Diagram 1 below) from the existing shareholder to the investor at no cost. However, this contract does not provide for rewards to the company if the profit target is successfully met, making it a one-way VAM. *Prima facie*, this indicates that Chinese investors are counterintuitively looking for guaranteed returns in venture capital investments, which are inherently high-risk. This is so especially considering that they are “accredited investors”, who are supposedly capable of appreciating the nature of their investments and bearing the corresponding risks. That investors

²⁷ Corporate management conditions include: (1) a substantial breach of contract, including the breach of warranty in the VAM agreement; (2) the sale of shares by the shareholders resulting in a change in control of the company; (3) disputes over intellectual property that adversely affect the prospects of the invested company listing; (4) changes to the key business of the company; (5) insolvency of the invested company; (6) serious deviations from plans adopted by shareholders at general meeting or by the board of directors; (7) the invested company's failure to obtain appropriate licenses; and (8) the invested company becoming no longer financially viable within 5 years after the investment.

²⁸ Corporate structure conditions include a change in the controlling shareholder of the invested company before listing; or a significant change in the core management team of the invested company.

²⁹ For example, the transactions between the invested company and related companies have an adverse effect on the interests of the investor.

³⁰ See *supra* note 8 for the methodologies used in the empirical study.

³¹ This sample is commonly used in the investigated hand-collected agreements by the authors. See *supra* 8 for the introduction of the empirical study.

refuse to do so and instead transfer all risks to entrepreneurs seems to indicate a severe lack of trust in the integrity of Chinese entrepreneurs, which will be elaborated upon later.

As illustrated in Diagram 3, 149 investigated disputes stipulate that the investor should be compensated via a share redemption. 73 use cash compensation. Share redemption and cash compensation are the most common outcome for losing a bet in VAM. The predominance of cash compensation is another unique feature of Chinese VAM; interviewed practitioners in Singapore³² and the UK³³ revealed that cash compensation has never been used in their venture capital investments. A further 16 VAM agreements provide even more flexibility to the investor, allowing him to choose how he wishes to be compensated. In particular, compensation by equity is not used solely but is used almost exclusively in conjunction with another form of compensation. Of the 253 investigated cases, equity transfers were used in conjunction with other compensation methods and presented as an alternative option in 22 cases.

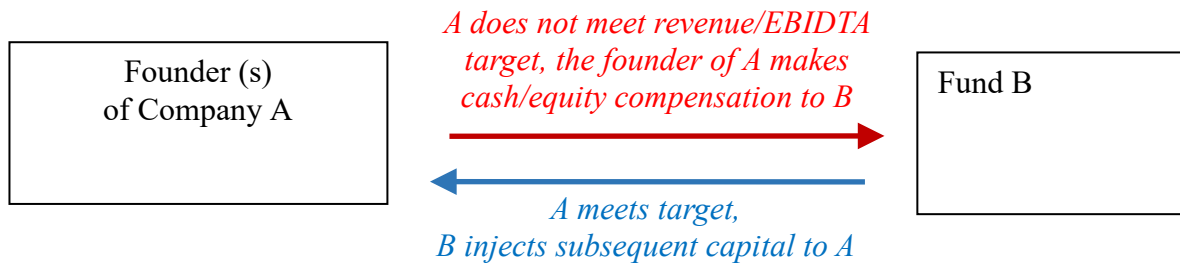
Table 1. Common Compensatory Structures of VAM

Compensatory Structures of VAM	Outcome when KPI is met	Outcome when KPI is not met
Cash-based	1) second round of capital injection based on pre-set price; 2) reduction of the accumulated dividends payable	1) no further capital injection; 2) cash compensation by the founders or the company
Equity-based	1) investors sell shares to the founders; 2) redeem shares on a formula basis or at a reduced price	1) allotment of new shares for free or at a discounted price; 2) equity transfer from the founders to the investors
Board control	Management receives a bonus.	Management gives up board seats to investors.

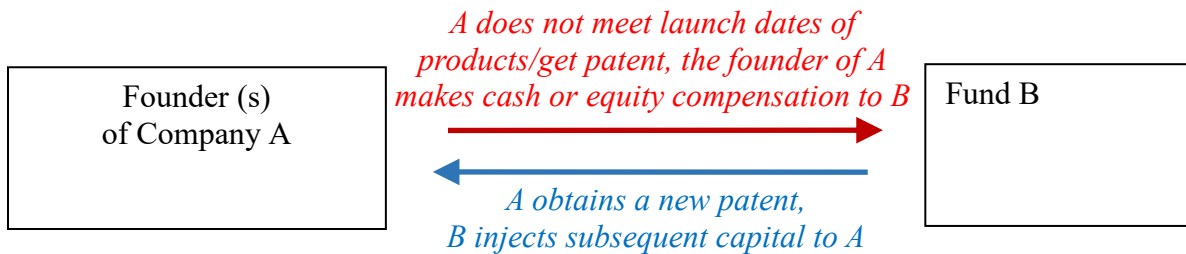
³² These interviews include an interview with the general counsel of Temasek Holding on May 30, 2019 in Singapore, an interview with two partners of WongPartnership LLP on 30 May 2019 in Singapore, an interview with two partners of Clifford Chance on 5 July 2019 and an interview with a partner of Allen & Gledhill LLP on 20 September 2019 in Singapore.

³³ Interview, Mr. Alex van Someren, Managing Partner, Amadeus Capital Partners, 15 November 2019, Cambridge, UK.

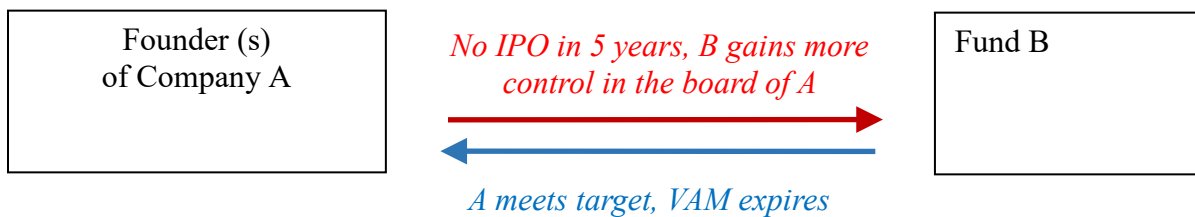
Sample 1: VAM Based on Financial KPI³⁴



Sample 2: VAM Based on Non-Financial KPI



Sample 3: VAM Based on Initial Public Offerings (IPOs)



Sample 4: VAM Based on Next Round's Valuation

A does not meet the valuation target,

³⁴ EBIDA refers to the earnings before interest, tax, depreciation and amortization.

*The founder of A makes cash or equity compensation to B
to ensure B's valuation is not higher than the current round*

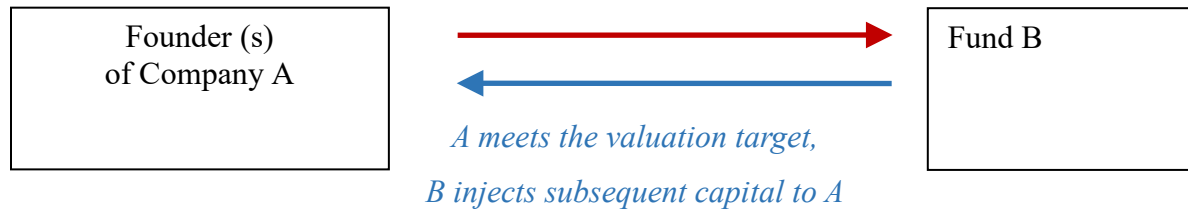


Diagram 1: Sample of Calculation Formula

(1) Compensation by cash

Amount of cash to be compensated

$$= \text{investment amount} \times \left(1 - \frac{\text{net profit realised of the financial year}}{\text{target profit of the financial year}} \right) - \text{amount of cash already compensated (if any)}$$

(2) Compensation by equity

Number of shares to be compensated

$$= \text{number of shares acquired from this investment} \times \left(\frac{\text{target profit of the financial year}}{\text{net profit realised of the financial year}} - 1 \right) - \text{number of shares already compensated (if any)}$$

Diagram 2: Types of Targets in VAMs³⁵

³⁵ See supra note 9. In this table, IPOs refer to the bet on whether the company can list their shares on the stock exchange by IPOs. Performance Goals refer to the bet on whether the company can meet the financial performance such as EBIDA within a specific period. Other conditions include, such as: 1) the status of the controlling shareholder and the actual controller of the target company changes before listing; 2) significant adverse changes in the legal environment; 3) substantial breach by any companies or by the sponsors, including but not limited to a serious violation of the representations and guarantees as agreed in the agreement; 4) completion of the next round of financing (Round A) within a certain period of time, and that the investor's pre-investment valuation before Round A shall not be lower than the agreed amount; 5) a intellectual property rights dispute over the technology used by the target company, for which the company is deemed responsible by the relevant organisations, or constitute a substantial obstacle to the listing of the company; 6) significant change in the core business of the target company; 7) the target company and its related companies enter into deals or guarantees that cause significant adverse impacts on Party A ; 8) the target company is placed under trusteeship or enters into the bankruptcy process; 9) significant violation of the business development plans, capital expenditure plans and budget plans adopted by shareholders' meetings or board meetings in the course of managing the target company; 12) significance changes in the core management team. "Unknow" cases refers to the cases that appeal to the courts for not enforcement of the arbitral awards. The judgements do not reveal the facts in those cases.

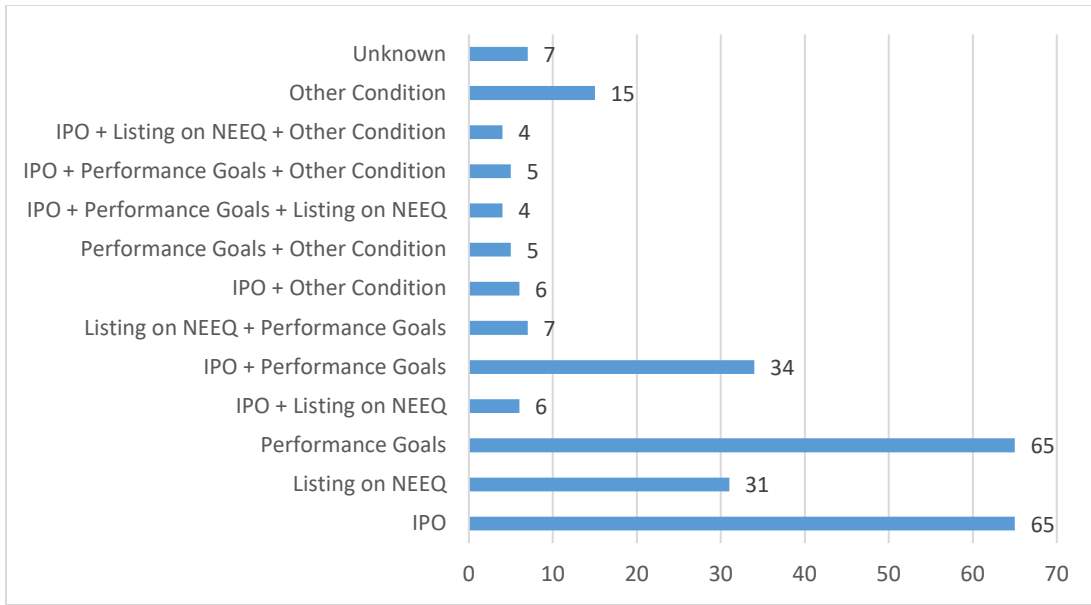
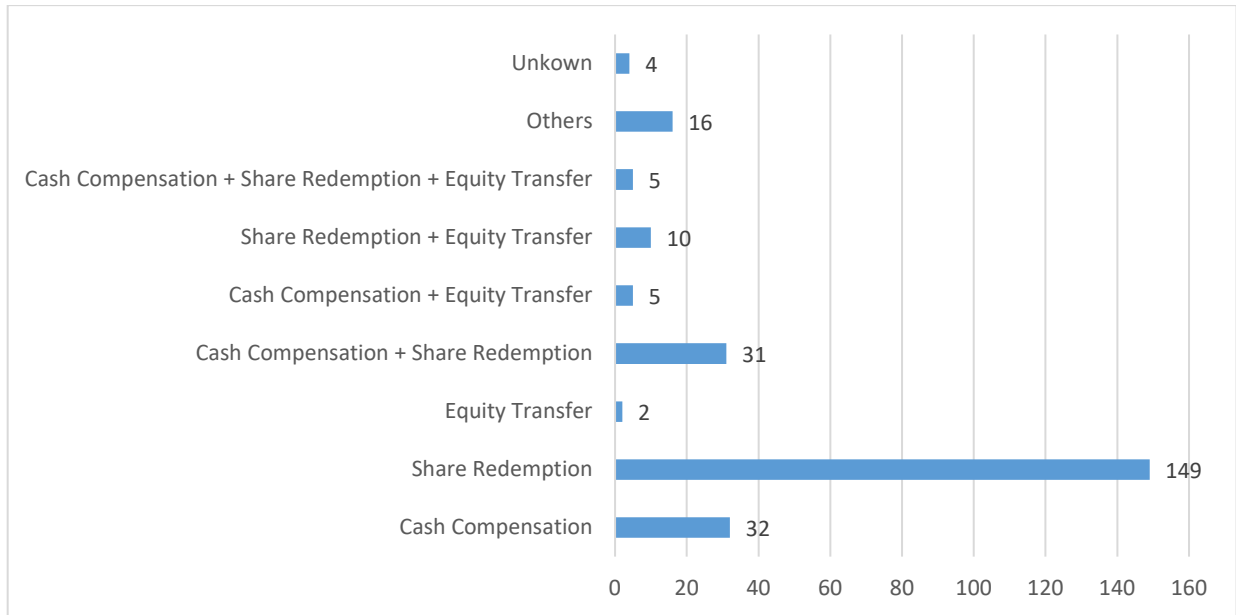


Diagram 3: Types of Outcomes in VAMs³⁶

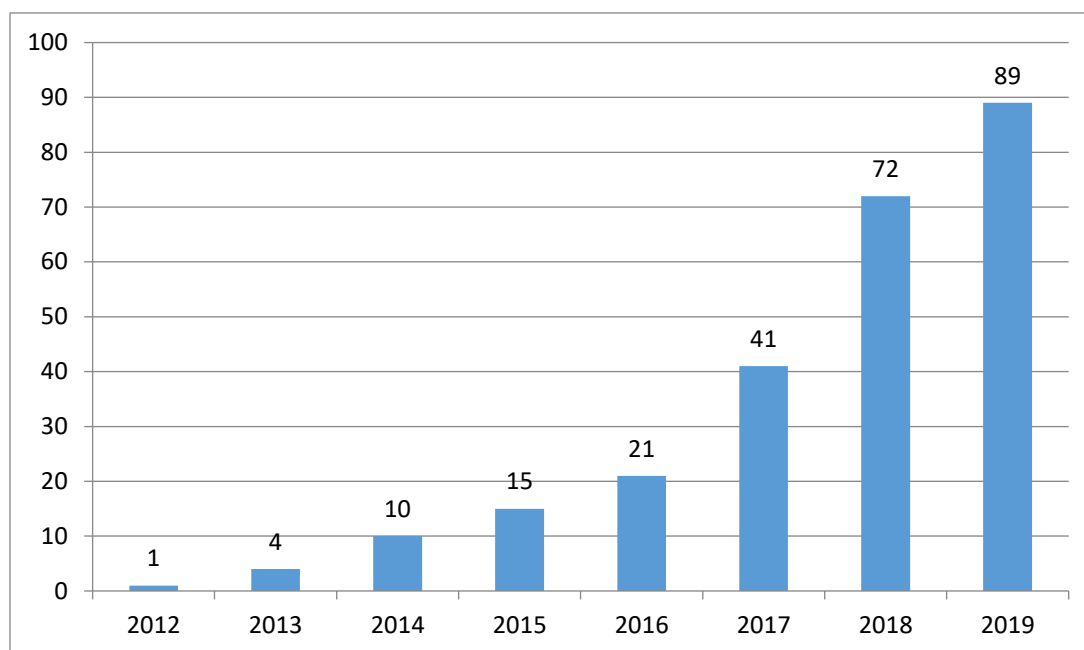


The popularity of VAMs has increased in China’s venture capital markets over the years, but so has their controversy. The 253 investigated judgements show that the number of disputes over VAMs have increased yearly between 2012 and 2019. As showed in Diagram 4, the number of reported cases peaked at 89 in 2019 as of 4 October 2019 and there are likely to be many other

³⁶ See *supra* note 9.

cases that either are ongoing or have not been reported. Also, among the 40 hand-collected investment agreements, a majority of 28 agreements contain a VAM clause.³⁷

Diagram 4: Number of PE/VC Disputes that Involved VAMs from 2012 to 2019³⁸



2.2. A Peculiar Chinese Arrangement?

A preliminary issue that may require clarification is whether VAM, as a contractual investor protection mechanism, is a peculiar one in the Chinese context. As it is a private arrangement, it is hard to know who the first drafter of VAM is. VAMs are not found in the model legal documents provided by the National Venture Capital Association (“NVCA”), model legal documents provided by Coyle LLP, the surveys conducted by Fenwick & West LLP, as well as the author’s empirical studies.³⁹ Interestingly, the earliest mentions of the use of VAMs in China are found in deals between US investors and Chinese companies, such as Morgan Stanley’s and CDH’s investments in Mengniu Dairy in 2003,⁴⁰ Morgan Stanley’s investments into Yongle Electronics

³⁷ See supra note 9 on the methodologies applied in searching these judgements.

³⁸ Id.

³⁹ Supra note 4.

⁴⁰ See further, Mengniu vs. Morgan Stanley and CDH, Sina Finance (June 19, 2005), <http://finance.sina.com.cn/stock/s/20050619/17241699972.shtml> (last visited July 3, 2019).

in 2005, and Goldman Sachs' investments into Yurun Group in 2005.⁴¹ It cannot be ascertained whether VAMs were created by American investors specifically for Chinese deals. However, in any case, the use of VAMs in the Chinese market has acquired unique Chinese characteristics, such as a predisposition for cash-based VAM that involves cash compensation for unsatisfactory corporate performance.⁴²

Nevertheless, VAMs bear some similarity to some contractual rights commonly found in US deals. For instance, redemption rights allow investors to collectively opt for share redemption by the company beyond a certain timeframe. To this extent, these rights are superficially similar to VAMs in that they both protect investors in light of future uncertainties concerning the portfolio company. However, there is a fundamental difference between the two: the ultimate aim of a redemption right is to enable investors to preserve what they have negotiated for in the original contractual bargain: a redemption mechanism allows investors to keep to their initial investment horizon by providing a back-up exit right when they cannot exit otherwise. VAM, on the other hand, aims to provide *compensation* from the portfolio company or the company's shareholders for failing to meet the pre-agreed targets.

Furthermore, investor protection provided by such redemption rights is substantially limited, as west coast venture capital deals in the US tend to provide much more for company-friendly weighted-average anti-dilution than investor-friendly full-ratchet anti-dilution, and redemption is rarely used in practice.⁴³ In contrast, VAMs essentially leverage on future exigencies that lie beyond the contours of the parties' initial contractual bargain, such as whether a company can obtain a certain profit margin in five years' time, to improve either party's position. This reveals the fundamental motivation behind using VAMs in China—investors are not confident that the bargain that they have secured is adequate to protect their investment. The reasons for such a lack of confidence are explored below in this article.⁴⁴

⁴¹ See further, Cases on VAMs, PE Daily (February 1, 2016), https://news.pedaily.cn/201602/20160201393132_all.shtml (last visited July 3, 2019).

⁴² This was seen from the author's hand-collected agreements and interviews with practitioners. See empirical studies in *supra* note 8. See also text accompanying note 32.

⁴³ This is empirically confirmed by the quarterly statistics of Fenwick & West LLP, an established US law firm in the West Coast venture capital industry, on Silicon Valley venture capital terms (hereinafter "Fenwick Reports"). See, for example, Silicon Valley Venture Capital Survey, Fenwick & West LLP (2019), *supra* note 4.

⁴⁴ See Part 3 of this article.

An “earnout” under an M&A also bears superficial similarity with VAMs. However, a VAM should not be confused with an earnout.⁴⁵ First, they are used in different transactional contexts. Earnouts, as mechanisms of contingent consideration in an M&A context, involve only potential payments from the buyer to the seller in case of fulfilment of key performance metrics. In contrast, VAMs are used in venture capital or private equity financing. A VAM primarily seeks to facilitate investor exit, where contingent payments can go in either direction, predominantly from the portfolio company to the investor,⁴⁶ depending on whether the bet-on target is achieved. Therefore, these two mechanisms have fundamentally different purposes: earnouts are a mechanism for consummating an M&A transaction whereas VAMs are predominantly used to allow investors to recover from a failed investment. Second, given that earnouts involve the buyer making contingent payments to the seller in tranches, earnouts are essentially a form of instalment payments. However, VAMs can involve returning to investor a part of the investment that is already paid out. Third, practically speaking, the prospects of payment for earnouts are much higher than those for most VAMs, as the former obligates deep-pocketed buyers but the latter obligates have-not entrepreneurs.

2.3.Explaining the Prevalence of VAM in China

2.3.1. Agency Costs, Information Asymmetry and Valuation Gaps

As Gilson notes, all venture capital contracting confronts three fundamental problems which are especially acute in high-tech startups: uncertainty, information asymmetries, and agency costs.⁴⁷ In the Chinese sector, the intensified agency problems and information asymmetry⁴⁸ may be the primary reason for the prevalence of VAMs. VAM agreements are structured to align the interests of the management with that of the investors to reduce agency costs and information asymmetries. Many VAMs also incorporate incentive plans for the managers, such as the release of the next

⁴⁵ See Contingent Consideration (Earnout) Valuation Under ASC 805, Equity Methods (2016), <https://www.equitymethods.com/valuation/complex-securities-valuation/earn-out-valuation/> last visited 3 July 2019.

⁴⁶ This was seen from the author’s hand-collected agreements and interviews with practitioners. See empirical studies in supra note 8.

⁴⁷ Gilson, supra note 1.

⁴⁸ Supra note 18.

round of capital injection and greater management control by the managers if the targets are met and *vice versa*.⁴⁹

However, agency costs and information asymmetry exist across all venture capital markets and this is an insufficient explanation. Further explanation can be found by examining the special features of the Chinese market. First, the author's interviews show that there exists a general lack of trust and confidence in the portfolio companies' valuation.⁵⁰ This is an important reason explaining the trend of inflated valuations of start-ups in recent years.⁵¹ This is attributable to factors such as the less sophisticated valuation market, the lack of a sound national credit system⁵² and the lack of effective enforcement of defaults in China.⁵³ Moreover, besides the general obstacles in ensuring the veracity and completeness of disclosures by a non-listed company, interviewed venture capitalists are usually confronted with strong resistance from the portfolio companies, especially in the presence of "unicorns" that have strong bargaining powers in the fundraising exercise.⁵⁴ Requests for financial information, without a display of commitment to invest or the strong enforcement of a non-disclosure agreement, could be seen as intrusions into the company's privacy.⁵⁵ Further, China's unicorn and start-ups are generally over evaluated.⁵⁶ As such VAMs function as a timely response to bridge the valuation gaps, mitigate concerns uncovered during due diligence and provide incentives for entrepreneurs.⁵⁷ For example, a VAM can stipulate that if the portfolio company reaches the agreed performance targets, the company and its shareholders are entitled to adjust its valuation upwards to compensate for their losses from

⁴⁹ YONG KWEK PING, *supra* note 22, at 116.

⁵⁰ Interview with Mr. Xu, Shiyue Hualong Capital in Shanghai on April 27, 2019. The interviewee mentioned a case where the invested company provided false information. In December 2018, the company claimed that they were working with one of Didi's subsidiaries. We also interviewed an associate of the subsidiary. The company colluded with the staff of that subsidiary and told us a half-truth. It was only months later, in April 2019, that we were told the full truth. While the company had worked with Didi's subsidiary in the past, the business relationship had been terminated in November 2018.

⁵¹ Interview with a founder of the Startup Salad in Shenzhen, China on December 1, 2019.

⁵² While China's credit rating system has been rapidly improving, it still has yet to replicate the standards found in the United States.

⁵³ See Lin Lin, *The Private Equity Limited Partnership in China: A Critical Evaluation of Active Limited Partners* 13(1) JCLS 185, 214 (2013).

⁵⁴ Telephone interview, Ms. Xu, Associate, Global Law Offices (shanghai office) on March 28, 2019. (The interviewee mentioned that some unicorns do not accept due diligence as they have strong bargaining power in fundraising.)

⁵⁵ See YONG KWEK PING, *supra* note 22, at 114, "This is understandable as many of these founders may be experts in their business but can be unsophisticated when it comes to the concept of capital markets and private equity investments".

⁵⁶ See Chen Yifan, *Bubbles in Unicorn Valuation*, Sohu (November 30, 2018), http://www.sohu.com/a/278900530_118622 (last visited 3 July 2019).

⁵⁷ Telephone interview, venture capitalist, Yincubator, June 12, 2017; telephone interview, fund manager, Cedar Fund, March 26, 2019. Personal interview with fund manager, Shiyue Hualong Fund, April 19, 2019, Shanghai, China; Personal interview with fund manager, Tembusu Capital, April 18, 2019, Shanghai. Telephone interview, Mr. Yuan, partner, Songhe Yuanwang, March 29, 2019. Interview, partner of Broad and Bright Law Firm, Shenzhen, December 2, 2019.

undervaluation; on the other hand, if the targets are not reached, investors are entitled to adjust the company's valuation downwards to compensate for their losses from overvaluation.

2.3.2. Lack of Convertible Securities

The prevalence of VAM could also be attributed to the lack of financial instruments for investors, typically the lack of an established practice of using convertible securities, such as convertible preferred stock⁵⁸ and convertible debts in China. This is due to the legal uncertainty and obstacles relating to such convertible securities under Chinese law.

First, at a more superficial level, convertible preferred stock provide an alternative method of addressing many concerns that underlie the use of VAMs. As we have seen above, VAMs are largely used to channel equity stakes or cash payments back to the investors if the portfolio company fails to achieve certain targets within a period of time. In the American context, the NVCA model documents provide for a similar outcome in the limited situation of a down round. A down round happens when a further round of financing, say round B, is happening at a price per preferred stock that is lower than the price in the previous round of financing, say round A. The financial implication of such a down round is that the portfolio company's performance is likely to have declined in the interim, such that it is now willing to sell stock at an even lower price.⁵⁹ Upon the occurrence of a down round, the standard NVCA certificate of incorporation⁶⁰ provides in excruciating detail for the adjustment of the conversion price of round A preferred stock into common shares. A lower price per preferred stock offered in round B results in the downward adjustment of round A preferred stock. As a result, holders of round A preferred stock are able to convert their stock into a greater number of common shares and effectively improve their equity position in the company on an as-converted basis at the expense of common shareholders. Note that this outcome is in substance similar to a VAM, which provides for a manual adjustment of the portfolio company's equity in favour of the investors. Thus, the concept of optional conversion

⁵⁸ Based on my interviews and the collected agreements, convertible preferred stock are not used in China's venture capital market, although it is common for venture capitalists to bargain contractual rights to protect their interests, such as liquidation preference and dividend preference.

⁵⁹ See What you need to know about down round financings, Cooley Go, <https://www.cooleygo.com/down-round-financings/> (last visited 3 July 2019).

⁶⁰ National Venture Capital Association Model Legal Document – Certificate of Incorporation, Clause on the right to convert at page 16.

and the adjustment of conversion price explain the bulk of the investors' concerns underlying the use of VAMs.

However, there are still material differences between convertible preference stock and VAMs. Most importantly, the adjustment of the conversion price in a NVCA-style certificate of incorporation is pre-conditioned upon the occurrence of a down round in the first place. In other words, the conversion price cannot be adjusted in the absence of a further round of financing. This shows that the overarching rationale behind the conversion mechanism is to act as an anti-dilution mechanism to prevent earlier investors from being unfairly disadvantaged when new investors come in at a lower point in the portfolio company's life cycle and purchase a bigger stake in the company. In sharp contrast, VAMs are triggered by mere poor performance.

Second, convertible preferred stock is used in line with a certain code of conduct between investors and portfolio companies, which would be incongruent with the use of VAMs. Convertible preferred stock have been famously conceptualised by Bratton and Wachter as a hybrid species of rights that sits on the fence between two grand private law paradigms—contract law and company law.⁶¹ On the one hand, preferred holders rely on specifically negotiated special rights in the investor-portfolio-company contract to protect their interests. On the other hand, preferred holders are also proper owners of the company and may possess certain vulnerabilities as shareholders. It therefore follows that a preferred shareholder has two mentalities and correspondingly two weapons to safeguard his rights when dealing with the portfolio company. One is contractual, in the form of previously negotiated, concrete and specified entitlements. The other is decisional, in the form of ongoing, flexible and non-determinant governance rights (although such rights are often limited in the case of preferred holders).

Convertible preferred stockholders therefore are accustomed to exercising both rights in the most sensible manner, which usually means that they expend efforts in negotiating for specific contractual rights at the start of the investment and leave the rest to on-going corporate governance measures. This could be why conversion rights for preferred shareholders, predicated on a specified formula of conversion price calculation, are essentially still pre-negotiated rights which

⁶¹ Bratton, William W. and Wachter, Michael L., A Theory of Preferred Stock 161 U. PA. L. REV. 1815 (2013).

are activated upon the occurrence of a certain event. In contrast, due to the lack of convertible preferred stock, Chinese investors, who are just holding common stock with a bunch of special contractual rights,⁶² may focus too heavily on their identity as fixed contractual right holders. This may explain their mentality of contractual entitlement, leading to interference even when things like corporate performance three years down the road and the prospects of IPO are better and more sensibly left to the realm of ongoing corporate governance. More research on investor behaviour in the Chinese market is definitely required to test this theory. But it is at least accurate to say that American venture capitalists appear to have functioned as value-adding preferred shareholders and contributed to the ongoing governance of the portfolio company during the investment,⁶³ instead of relying purely on their pre-negotiated contractual rights.

However, convertible preferred shares are not allowed under Chinese law.⁶⁴ Currently regulations make extremely limited allowance for the use of preferred stock. Only selected listed companies and non-listed public companies are allowed to issue preferred stock, restricting the pool of portfolio companies that are able to issue them.⁶⁵ Moreover, although the concept of preferred stock is recognised in China, conversion is not allowed.⁶⁶

⁶² Interview with Mr. Guo, Partner of Huashang Law Office in Shenzhen on December 1, 2018; Interview with Ms. Zou, Partner of Grandall Law Firm on April 26, 2019 in Shanghai. Telephone interview with Ms Shao, legal counsel of Gaorong Capital on May 29, 2019. In practice, it is common for investors to contract in preference rights in distribution of dividend and in the event of liquidation. However, these contractual rights have to be cleared and removed from the agreements when the portfolio company go public. Interestingly, if the company is unable to proceed with an IPO, these special preference rights can be “restored” back to the agreements.

⁶³ See generally Gilson, *supra* note 1.

⁶⁴ See Opinion on Pilot Program of Preferred Shares by the State Council 《国务院关于开展优先股试点的指导意见》(GUOFA (2013) NO. 46), effected on November 30, 2013, Central People’s Government (2013), http://www.gov.cn/zwqk/2013-11/30/content_2539046.htm (last visited July 3, 2019) and Measures for the Administration of the Pilot Program of Preferred Shares, 《优先股试点管理办法》(CSRC NO.97), effected on March 21, 2014, China Securities Regulatory Commission, http://www.csrc.gov.cn/pub/heilongjiang/xxfw/hljflfg/201602/t20160214_291252.htm (last visited July 3, 2019).

⁶⁵ According to the State Council Opinions and the Pilot Measures on Preferred Stock, the entities eligible to issue preferred stock include: 1) in the case of public offerings of preferred stock, CSRC-sanctioned listed companies, namely companies whose ordinary shares are a constituent of the SSE 50 Index, companies which are issuing preferred stock with a view to use the proceeds to acquire or merge with other listed companies, or companies which are repurchasing ordinary shares with a view to reduce registered capital; 2) in the case of private offerings of preferred stock, listed companies (including foreign-registered listed companies) and non-listed public companies.

In any case, as both listed companies and non-listed public companies are joint stock companies either listed on stock exchanges or registered on the NEEQ, limited liability companies are not allowed to engage in any preference stock offerings, public or private, under the current regulations.

⁶⁶ Article 33 of the Pilot Measures on Preferred Stock stipulates that listed companies shall not issue preferred stock that is convertible into ordinary stock. However, commercial banks may issue preferred stock that is mandatorily converted into ordinary stock upon the occurrence of non-public offering trigger events in accordance with relevant laws such as the administrative measures for the capital of commercial banks. In addition, although Article 15 of the Interim Measures for the Administration of Venture Capital Firms 《创业投资企业管理暂行办法》(Order No. 39 [2005], National Development and Reform Commission), effected on 1 March 2006 provides that “pursuant to investment agreements entered into with portfolio companies, venture capital firms may invest in non-listed enterprises through equity-equivalent means such as common stock, preferred stock and convertible

Another widely used convertible security in venture financing is convertible bonds. These are quasi-debt instruments which, when signed into existence, are debts but are capable of being converted into equity upon voluntary or mandatory conversion before the maturity date. Convertible bonds also answer many of the concerns that investors wish to address by the use of VAMs. First, convertible bonds also avoid the valuation problem at the contracting stage as the investment quantum is a debt amount with no reference to the portfolio company's valuation. The valuation issue only comes in at a later point in time when there is a possibility of conversion, such as when a round of preferred stock investors comes in, where the bond holders' equity stake upon conversion will be determined by an adjustable conversion price and the incoming round's valuation. Second, one of the effects of some VAMs is to salvage what is actually an undiscovered failed investment by providing for cash compensation upon catastrophic performance. This is similar to convertible bonds, which possess the characteristics of both equity and debt, entitling investors a timeframe (namely between contracting and maturity) to assess the company's performance so as to decide whether to stay as creditors with a prior claim in insolvency or to convert their holdings into shares.

Nevertheless, the market for convertible bonds is far from established in China. The first issuances of convertible bonds for non-listed companies occurred only in 1998.⁶⁷ As of October 2017, there were only 23 convertible bonds and 13 exchangeable bonds in the public market.⁶⁸ The figure is even more miniscule for privately issued convertible bonds, which were only legally allowed since 2017,⁶⁹ amounting to 6 issuing companies having raised a total of 0.34 billion RMB as of 2018.⁷⁰

The underuse of convertible bonds as a financing instrument is largely attributable to the defective institutional design that causes intending issuers to be handicapped. Only two groups of companies are currently allowed to issue convertible bonds, and both face substantial regulatory obstacles.

preferred stock", these measures are merely departmental regulations and not law; nor have specific provisions been put in place as to how preferred stock can be used in this regard.

⁶⁷ See A Serious Look at Convertible Bonds for the New Third Board, JRJ.com (2017), <http://bond.jrj.com.cn/2017/11/08150823357314.shtml> (last visited 3 July 2019).

⁶⁸ Id.

⁶⁹ Id.

⁷⁰ See Recommendations for Reform in Light of the Low Take-up Rate of Convertible Preferred Stock and Convertible Bonds on the New Third Board, Yicai (2019) <https://www.yicai.com/news/100132401.html> (last visited July 3, 2019).

The first group consists of public listed companies, which are able to issue convertible bonds only upon fulfilling a long list of prerequisites stipulated in the PRC Company Law and the PRC Securities Law.⁷¹ The second group involves non-listed public companies.⁷² More specifically,⁷³ the guidance of CSRC 2017 made innovative companies and start-ups authorised private issuers. This particular emphasis on innovation and entrepreneurship, however, prevents the popularising convertible bonds for other non-listed public companies. Finally, much procedural red tape exists in getting issuances approved as the process involves cross-institutional regulation by the supervising bodies for both the issuance of bonds and the transfer of shares upon conversion, which deter potential issuers from opting for convertible bonds in the first place.

2.3.3. Legal Obstacles against Contractual Protections

One may argue that Chinese venture capitalists may bargain for covenants such as liquidation preference and redemption rights to protect their interests, instead of relying on VAMs. However, several terms commonly used in the US are not readily recognized and enforceable under the PRC Company Law.⁷⁴

⁷¹ Article 161 of the PRC Company Law provides that a listed company may, upon a resolution of the shareholders' assembly, issue corporate bonds that may be converted into stock and shall work out concrete conversion measures in the corporate bond issuance plan. Further, Article 16 of the PRC Securities Law provides that a public issuance of corporate bonds shall meet the following requirements: (1) The net asset of a joint stock limited company is no less than RMB 30 million yuan and the net asset of a limited-liability company is no less than RMB 60 million yuan; (2) The accumulated bond balance constitutes no more than 40 % of the net asset of a company; (3) The average distributable profits over the latest 3 years are sufficient to pay the 1-year interests of corporate bonds; (4) The investment of raised funds complies with the industrial policies of the state; (5) The yield rate of bonds does not surpass the level of interest rate as set by the State Council; and (6) Any other requirements as prescribed by the State Council.

⁷² Measures of Corporate Bond Issuance and Operation, (CSRC Order No. 113), effected on January 5, 2015, Shanghai Stock Exchange (2015), <http://www.sse.com.cn/lawandrules/regulations/csrcorder/c/3976177.pdf> last visited July 3, 2019, where Article 12 provides that Corporate bonds issued by a listed company or by an unlisted public company whose stock is transferred publicly may be attached with terms on warrants or convertible equity... The issue of corporate bonds under terms on warrants or convertible equity by a listed company shall comply with relevant provisions of the Measures for the Securities Offering of Listed Companies and the Interim Measures for the Administration of Securities Offering by Companies Listed on the Growth Enterprise Market. The provisions governing the issue of corporate bonds under terms on warrants or convertible equity by an unlisted public company whose stock is transferred publicly shall be separately developed by the CSRC.

⁷³ Rules For Private Placement Of Convertible Bonds By Innovative Companies And Start-ups (For Trial Implementation) (2017), jointly issued by Shenzhen Stock Exchange, National Equities Exchange and Quotations ("NEEQ") and China Securities Depository and Clearing Corporation <http://m.mondovisione.com/media-and-resources/news/rules-for-private-placement-of-convertible-bonds-by-innovative-companies-and-sta/> (last visited July 3, 2019).

⁷⁴ PRC Company Law, amended and effected on October 26, 2018, National People's Congress (2018). Many of these special contractual clauses are directly imported and are not altered to fit into the existing Chinese legal framework. However, the potential conflicts are not that apparent as disputes in the Chinese venture capital industry are typically not litigated and, even if litigated, are often resolved via settlement. (Interview with Lawyer Yuan Lizhi, September 4, 2017).

Take preference right in liquidation as an example. The PRC Company Law states that “the residual assets of a company after the assets are respectively applied to the payment of liquidation expenses, employees’ wages, social insurance premiums and statutory compensation, and outstanding taxes shall be distributed, in the case of a limited liability company, in proportion to the capital contributions of its shareholders, and in the case of a joint stock company, in proportion to the shareholdings of its shareholders”.⁷⁵ There is scholarly disagreement as to whether this is a mandatory provision or just a default one. In the former case, the law prescribes that both limited liability companies and joint stock companies only distribute liquidation proceeds in proportion to either the capital contributions or the shareholdings of their shareholders. Shareholders may not contract out of this provision and investors cannot receive liquidation preference in priority to other shareholders despite the presence of liquidation preference provisions. In the latter case, portfolio companies and venture capitalists may be able to depart from this default position and adopt liquidation preference provisions.

The inclusion of liquidation preference in articles of association may also run into practical problems when trying to register the portfolio company with the PRC Administration of Industry and Commerce (“AIC”). Some local AICs only accept articles of association that are modelled after their standard forms.⁷⁶ Therefore, if the articles of association contain provisions relating to liquidation preference, which are not expressly established in PRC Company Law, these AICs may read the articles of association as incongruent to their standards and thus refuse registration. In order to mitigate the enforceability problem in light of the legal uncertainty, most examined agreements state that where the liquidation priority clause is invalid or unenforceable, the pre-existing shareholders shall compensate the venture capitalists,⁷⁷ subject to the potential unenforceability of such contractual terms under Chinese law.⁷⁸

⁷⁵ Paragraph 2 of Article 186 of the PRC Company Law.

⁷⁶ Interview with Mr. Guo, Partner of Huashang Law Office in Shenzhen on December 1, 2018; Interview with Ms. Zou, Partner of Grandall Law Firm on April 26, 2019 in Shanghai.

⁷⁷ See *supra* note 7 on the explanation of the collected agreements.

⁷⁸ The PRC Company Law may not recognize liquidation preference and venture capitalists run the risk of being unable to enforce the liquidation preference clause in their Investment Agreements. Paragraph 2 of Article 186 of the PRC Company Law states that the residual assets of a company after the assets are respectively applied to the payment of liquidation expenses, employees’ wages, social insurance premiums and statutory compensation, and outstanding taxes shall be distributed, in the case of a limited liability company, in proportion to the capital contributions of its shareholders, and in the case of a joint stock company, in proportion to the shareholdings of its shareholders. There is scholarly disagreement as well as practical uncertainty as to whether this is a mandatory provision or just a default/voluntary one.

2.3.4. Insufficient Legal Protections of Investors

Another factor that provides impetus for the prevalence of VAM in China's market is arguably the lack of effective legal protection for shareholders, particularly minority shareholders. This is largely due to the lack of comprehensive fiduciary duties owed by directors in a corporation, and the defective private enforcement of these duties by shareholders.⁷⁹

First, the duty of loyalty (*zhongshi yiwu*) and the duty of due diligence (*qinmian yiwu*) were officially introduced in China in 2006, when the revised PRC Company Law was enacted. PRC Company Law states that the directors, supervisors (in the supervisory board) and senior executives of a company shall "... bear the duties of loyalty and due diligence towards the company".⁸⁰ However, the law does not expressly define the duty of loyalty but simply provides a short list of prohibited activities, including: (1) misappropriation of company funds; (2) opening accounts with the company capital in a name other than the company's; (3) providing capital to other parties with the company's capital or providing security to third parties with the company's assets, without authorization from the constitution, or obtaining consent from shareholders' general meeting or the board of directors; (4) conclusion of contracts or conducting self-dealing transaction with the company, without consent from shareholders; (5) expropriation of company opportunities for self-interests or for the interests of other parties without consent from shareholders; (6) conducting a business that competes with the company; (7) misappropriation of company commission; (8) disclose of company's secrets; and (9) other behaviours that are in breach of the duty of loyalty.⁸¹ Arguably, the narrow scope of this list of activities is far from enough to cover all potential situations that fall within the category of the duty of loyalty in common law. Moreover, the duty of diligence is not defined clearly under the PRC Company Law either.⁸² The PRC Company Law is silent on the the tests of skill and diligence, making the duty of care difficult to apply in judicial practises.⁸³

⁷⁹ Supra note 53, at 91.

⁸⁰ Article 147 of the PRC Company Law. See also Lin Lin, Regulating Executive Compensation in China: Problems and Solutions 32(2) J. LAW AND COMMERCE 207, 238-239 (2014).

⁸¹ Article 148 of the PRC Company Law.

⁸² To help the public have a better understanding of the duty, Article 98 of the CSRC Guidelines for Articles of Association of Listed Companies 2006 specifies that directors' duty of diligence includes: (1) treating all shareholders equally; (2) understanding the business operations of the company; (3) endorsement on the regular reports of the company in written form and ensuring that the disclosed information is true, accurate and complete; and (4) providing information and materials to the supervisory board.

⁸³ Chinese courts use different tests in judging directors' duties in judicial practises. See Wang, J. (2017), Enforcing Fiduciary Duties as Tort Liability in Chinese Courts in R.Huang & N. Howson (Eds.), Enforcement of Corporate and Securities Law: China and the World (pp. 185-206), Cambridge University Press. For fiduciary duties in China, see also N. Howson, "Fiduciary Principles

Second, in the US, a separate fiduciary duty to act with fairness is owed by majority shareholders to minority, which features prominently in the context of venture capital investments where it is increasingly common for venture capitalists to wield control under contractual arrangements despite holding a minority of the total share capital.⁸⁴ English law may also impose directors' duties on a person who is not formally a director by regarding him as a shadow director if he acts like one; thus, a controlling shareholder who is very much involved in the company's business and decision-making may be seen in law as a shadow director.⁸⁵ However, controlling shareholders' fiduciary duties is not specified by the PRC Company Law. Only the Code of Corporate Governance for Listed Companies ("the Code") and the Guidelines on the Bylaws of Listed Companies issued by the CSRC provide that the controlling shareholders of listed companies owe duties of good faith to the Company.⁸⁶

Third, although the PRC Company Law provides the legal basis for shareholders to bring a derivative action against directors, there are several problems with the derivative action regime, such as the high preconditions of bringing a derivative action, the free-rider problem and the high cost of litigation.⁸⁷ For example, the notice requirement is stricter than the counterpart action in the US in the sense that it can be waived only in cases of emergency.⁸⁸ Also, contingency fee arrangements are not recognized in China, making derivative action less popular in China as compared to the US. Moreover, there is naturally no common law derivative action as China is a civil law jurisdiction. Further, oppression allows investors who have been personally prejudiced

in Chinese Law" in Evan J. Criddle, Paul B. Miller, and Robert H. Sitkoff eds, the Oxford Handbook of Fiduciary Law, Oxford: Oxford University Press, 2019, 603-622.

⁸⁴ Supra note 61, at 1876.

⁸⁵ See Shadow directors: definitions and duties, UK Practical Law (2005), [https://uk.practicallaw.thomsonreuters.com/7-201-2427?transitionType=Default&contextData=\(sc.Default\)&firstPage=true&bhcp=1](https://uk.practicallaw.thomsonreuters.com/7-201-2427?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1) last visited 3 July 2019.

⁸⁶ Article 63 of the Code states that "a controlling shareholder or actual controller owe fiduciary duty for the listed company and other shareholders. A controlling shareholder shall exercise the rights of shareholders and perform the obligations of shareholders according to the law for the listed company controlled by it. No controlling shareholder or actual controller shall utilize its controlling power to damage the lawful rights or interests of any listed company or other shareholders, or utilize its control over the listed company to seek illicit interests." Nevertheless, it should be noted that the Code as soft law is not legally binding and cannot be enforced by the court. See also Lin Lin, Code of Corporate Governance: Lessons from Singapore to China 40(7) THE COMPANY LAWYER 227 (2019).

⁸⁷ Article 151 of the PRC Company Law. See also Huang, (Robin) Hui, The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform 4 (2) BERKELEY BUS. L. J. 227, 239 (2008); Donald C. Clarke & Nicholas C. Howson, "Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China", in DAN W. PUCHNIAK, HARALD BAUM & MICHAEL EWING-CHOW (ed.), THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH (Cambridge University Press, 2012), at 243-295.

⁸⁸ Id.

in the running of a company to bring a personal claim against corporate controllers to vindicate justice. However, oppression is not applicable in China.

Further, the fact that leveraged buy-outs are not prevalent in China due to regulatory restrictions⁸⁹ may also contribute to the prevalence of VAM in China. Many private equity investments are minority-stake investments and VAMs are used as a pragmatic mechanism to maximize investment returns.

Last but not the least, venture capitalists may argue that the benefits of using VAM to protect their interests would outweigh the transaction costs involved (including negotiation costs and the substitute costs of conducting due diligence). Arguably, venture capitalists are generally in a better bargaining position, especially in China where there is serious capital gap problem for start-ups who are unable to raise financing from IPOs, Chinese banks and bond markets.⁹⁰ Thus, if venture capitalists wish to impose VAMs on portfolio companies out of the fears outlined above,⁹¹ entrepreneurs in need of cash may have little choice other than to accept these terms and “bet”.⁹²

2.3.5. An alternative Exit for Investors

VAMs that provide for management buyout arguably serve as an alternative exit option for the venture capitalists.⁹³ When the performance of the portfolio company suffers, IPOs, M&As and trade sale are often impractical, and liquidation is unlikely to adequately compensate investors. Redemption by the limited liability company and the joint stock company can only occur in extraordinary circumstances prescribed under Articles 74 and 142 of the PRC Company Law respectively,⁹⁴ none of which includes a failure of investment. Even if company redemption were

⁸⁹ Regulatory rhetoric against the use of leverage reached a high-water mark in 2016 where the CSRC chairman condemned leveraged buy-outs financed by high-risk insurance products as “barbaric” and such asset managers as “robbers”. Recent consultation documents for banking and asset management regulation have also focused on limiting leverage. See Regulation of Asset Management Business of Financial Institutions (Consultation Draft), People’s Bank of China (2017), <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3420451/index.html> last visited July 3, 2019; see also Interim Regulations on Securities and Futures Institutions Private Equity Asset Management Business Operation and Management, CSRC (2016), <http://www.csrc.gov.cn/shanghai/xxfw/gfxwj/201612/P020161202574865079353.pdf> last visited July 3, 2019.

⁹⁰ See Lin Lin, *supra* note 18.

⁹¹ See Part 2 Section 2.1 in this article.

⁹² Telephone interview with Ms. Yin, Associate of Hankun Law Office (Shanghai office); telephone interview with Ms. Jia, Associate of King & Wood Mallesons Law Office (Beijing office) on March 26, 2019.

⁹³ For the exits of venture capital-backed companies in China, see Lin Lin, *Venture Capital Exits and the Structure of Stock Markets: Lessons from China* 12(1) *ASIAN J. OF COMPARATIVE. L.* 1 (2017).

⁹⁴ Article 142 provides that a company shall not purchase its own shares except under any of the following circumstances: (1) To

to be done through capital reduction, Article 177 of the PRC Company Law provides that any distribution back to shareholders upon an equity reduction shall take into account the necessary payments needed to satisfy creditors. Thus, the only realistic exit when an investment turns out to be unprofitable is for the founders of the portfolio companies to purchase shares from the venture capitalists. That is not to say, however, that this solution is waterproof for concerned investors—it may often be the case that entrepreneurs have no other personal assets apart from their stake in the company, such that the contractual remedy is practically unenforceable.

3. Problems with VAM

3.1. Complexity and Negative Spillover Effects

Having accounted for various reasons which may, individually or collectively, popularise VAMs in China, it does not necessarily mean that working with VAMs is a walk in the park. Various theoretical and practical difficulties haunt the drafting, negotiations and enforcement of VAMs, and this section shall start by accounting for the complexity of reducing VAMs in contractual language and some of the negative spillover effects of regrettable drafting on parties' behaviour and dynamics.

First, how do parties choose and define the target measure? When non-financial measures take the form of business-specific performance measures, such as the number of active users or the average profit for a particular product of a tech company, there can be two points of contention. First, parties' agreement over such measures may expire as circumstances change. Considerable time is usually required before start-ups can pin down with certainty their products and strategies, possibly rendering business-related targets identified at the point of contracting anachronistic. Second, there is considerable risk of data manipulation by the portfolio company when it comes to assessing such measures, given that it has possession of relevant business-sensitive data, which may not be verifiable by any existing independent standard. Interesting examples of such a manipulation have

reduce the registered capital of the company; (2) to merge with another company that holds its shares; (3) to use shares for employee stock ownership plan or equity incentives; (4) a shareholder requests the company to purchase the shares held by him since he objects to a resolution of the shareholders' meeting on the combination or division of the company; (5) to use shares for converting convertible corporate bonds issued by the listed company; (6) it is necessary for a listed company to protect the corporate value and the rights and interests of shareholders.

emerged in the Chinese market in recent years including the practice of paying people to purchase products so as to create an appearance of popularity (“*shuadan*”).

If the chosen target measure is a financial one touching on the portfolio company’s profit margins or revenue, defining the target becomes even trickier. On the one hand, there is a necessity to be numerically precise in defining the target so as to allow an uncontroversial judgment of whether the target has been attained. However, the downside to objective numerical definitions is that they can be overly complex and specialised, such that the portfolio company may find it hard to coordinate its corporate strategies so as to work towards meeting the target. Furthermore, the growth and potential of a company is properly reflected by a holistic analysis of various indicators and not a single numerical figure. This is especially for early-stage start-ups that tend to experience prolonged loss-making periods. Indeed, for many tech start-ups, the bigger their customer base is, the less profitable they are likely to be in the short term, creating a direct contradiction between growth and profitability. Finally, financial measures may just as well be subject to the same risks of data manipulation and “*shuadan*” practices discussed above. Some interviewed venture capitalists have thus observed that it is nearly impossible to design a perfect indicator of success.⁹⁵

Moreover, how do parties meaningfully agree on the standards of success and failure? As mentioned above, the VAM terms are likely to be determined by the balance of the parties’ relative bargaining power, such that the final agreed position may have little to do with what is the optimal balance of interests as between both parties. Instead, it is more likely to represent the best position for the stronger party. If the venture capitalist is in a strong position, it may push for an overly high standard of success to pressurise the management and maximise its own benefits; if the portfolio company is in a strong position, it may also volunteer for or accept a high standard of success in order to demonstrate confidence, trading risk for more equity investments in future. In these circumstances, VAM targets are often inflated, resulting in a high number of failures, which defeats the purpose of venture financing. Another consideration is that the prospects of future corporate affairs are always subject to, and sometimes overridden by, factors extraneous to the portfolio company’s performance itself. For example, as shown in the case of Southern Beauty,⁹⁶

⁹⁵ Telephone interview Mr. Tian, a partner of the Songheyuanwang Capital on March 26, 2019.

⁹⁶ See *infra* note 101.

negative changes in the general economic environment and suspensions of IPOs due to changes in regulatory policies⁹⁷ can be fatal to the agreed VAM targets, regardless of how hard the management tries to meet them.

Further, how do parties account for the potential negative spill-over effects that VAM terms may have on their future incentives and working relationship at large? VAMs by nature alter the incentive structure of management by artificially breaking down the company's life span into pre-VAM and post-VAM stages. Before VAM targets are assessed,⁹⁸ managers are naturally incentivised to adopt a short-termed mentality. For example, they may prize possibly irrational expansion over internal stabilisation if the VAM target touches on revenue. After VAM targets have been reached, there can be an abrupt loss of continuity as management loses the driving force to produce consistent corporate performance.

Last but not the least, it is extremely costly and time-consuming to negotiate and structure the amount, period, targets and outcome of a VAM. VAMs envisage thresholds and targets in a very uncertain future, which can be hard to pin down in precise contractual language. The incomplete contract theory⁹⁹ has exposed a primary weakness of the contract as a governing paradigm of a commercial relationship to be incompleteness, thus leading to potentially inhibitive costs of perfecting that contract in future.

3.2. Increasing Distrust between the Parties

Given that VAMs are result-oriented and thus bifurcates party interests, there would be an inherent tendency for distrust among parties that make use of VAMs which would distort their working relationship. For example, when the VAM provides for the dilution of controlling rights of the management upon an event of failure, this could thwart the confidence of the management team and breed defensiveness among them, which may adversely affect the future performance of the company. In fact, the running thread in all the design difficulties enumerated in the subsection

⁹⁷ See supra note 93.

⁹⁸ The author's hand-collected private agreements show that most of the VAMs specify that the period of VAM lasts for 3 years. Some VAM only lasts for one year.

⁹⁹ See for example, Sanford J Grossman & Oliver D Hart, The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration (1986) 94(4) J. OF POLITICAL ECO. 691.

above is that the form of VAMs, being apparently concerned with investor protection, is actually predisposed to introduce skepticism and distrust into the investor-entrepreneur relationship by waterproofing an investment at all costs—mostly at the costs of entrepreneurs.

Apart from the VAM, some venture capitalists even asked the entrepreneurs to provide additional personal guarantees with their personal assets, which have commonly led to the bankruptcies of entrepreneurs when an investment goes south.¹⁰⁰ In their fixation to transfer risks from themselves to entrepreneurs, Chinese investors seem to have adopted a mentality of waterproof profit-earning instead of calculated risk-taking, the latter of which is more in line with the nature of venture capital investments. In addition, there exists strong public disapprobation against VAMs in China which are seen as a calculative move by investors to take advantage of portfolio companies.¹⁰¹

3.3. Legal Uncertainty

There is no codified law on the definition and legality of VAM. The validity of VAMs has experienced challenges from the Chinese courts and arbitration institutions,¹⁰² including a series of judicial decisions,¹⁰³ following the landmark Supreme People's Court case of *Haifu*.¹⁰⁴

In the *Haifu* case, Haifu Investment Co., (“Haifu”), a private equity firm entered into a Capital Increase Agreement with (1) Gansu Shiheng Nonferrous Resources Recycle Co., (“Shiheng”), which was wholly owned by Hong Kong Diya Co. (“Diya); (2) Diya, and (3) Ms. Lu Bo, the general manager and legal representative of Shiheng in 2007. As a result of Haifu's investment, Shiheng became an Equity Joint Venture (“EJV”). Haifu and Diya subsequently entered into an Equity Joint Venture Agreement. There was a cash-based VAM provision in the Capital Increase

¹⁰⁰ Interview with Shao Jun, a partner of the Yuantai Law Office in Shanghai on April 20, 2019.

¹⁰¹ See Southern Beauty, the Fiasco, Su Longfei (2016), http://www.p5w.net/xcf/201607/t20160707_1510312.htm last visited 3 July 2019. In 2008, CDH Investment offered to invest in Southern Beauty, on the condition that a VAM agreement be installed in the investment agreement with the company. The VAM agreement was a one-way clause, which stipulated that the company had to succeed in applying for IPO in 5 years or else it would be obliged to buy back all CDH's shares at a premium. The IPO attempts failed and Zhang Lan was forced to give up her controlling rights in South Beauty.

¹⁰² It must be noted that Chinese arbitral tribunals seem more open to give effect to VAMs. An arbitral award made by the CIETAC in January 2014 ([2014] CIETAC 0056) recognised a VAM agreement between the investors and the portfolio company as valid. See Chen Fu & Zhang Wei, Arbitral Awards on VAMs, <http://www.shui5.cn/article/69/73971.html> ; http://www.sohu.com/a/169759445_481798

¹⁰³ See supra note 9. Small and Medium-sized Enterprises (Tianjin) Venture Capital Fund Partnership LLP vs. Lu Shihai (dispute over a contract) (2015) E Wu Han Zhong Min Shang Wai Chu Zi No. 00304 and etc.

¹⁰⁴ Haifu Investment Co., Ltd. of Suzhou Industrial Park vs. Gansu Non-ferrous Metal Resources Recycling Co., Ltd., Hong Kong Diya Co., Ltd., Lubo (dispute over capital increase) (2012) Min Ti Zi No. 11 (苏州工业园区海富投资有限公司与甘肃世恒有色资源再利用有限公司、香港迪亚有限公司、陆波增资纠纷案 (2012) 民提字第 11 号).

Agreement (clause 7.2). Under the agreement, Haifu would receive cash compensation from Shiheng if Gansu Shiheng's net profit for 2008 was less than RMB30 million. If Shiheng failed to pay such compensation, Haifu could then demand Diya to pay the same compensation.¹⁰⁵ When Shiheng and Diya both refused to honour the cash compensation obligation upon the failure of the company to meet the performance target, Haifu sued.

The Supreme People's Court held that the VAM claim against Shiheng, the portfolio company, was unenforceable, as it had effectively guaranteed a fixed return to Haifu irrespective of Shiheng's actual business performance and profits. Such a guaranteed return violated the requirement under Article 8 of the Sino-Foreign Equity Joint Venture (EJV) Law,¹⁰⁶ in which the shareholders in an EJV are only entitled to share the net profits of the EJV pro rata to their respective equity interests in the EJV. Consequently, by entitling Haifu to directly obtain assets from the company without going through the statutory process of profit distribution, clause 7.2 impaired the interests of Shiheng and its creditors and was an abuse of shareholder's rights prohibited by Art 20 of the Company Law.¹⁰⁷ Lastly, clause 7.2 was dissonant with the risk sharing principle, as it enabled Haifu to secure a return without bearing the risks of the company's operation. Since the VAM agreement violated mandatory legal provisions, the contract was held to be invalid under Article 52 of the Contract Law.¹⁰⁸ In contrast, the claim against the controlling shareholder, Diya, was enforceable.¹⁰⁹ This was because Haifu's claim did not harm the interests

¹⁰⁵ This provision was not triggered as the investment deal broke down the next year.

¹⁰⁶ Paragraph 1 of Article 8 of the PRC Sino-foreign Equity Joint Venture Law provides that "after payment of equity joint venture income tax on an enterprise's gross profit, pursuant to the tax laws of the People's Republic of China, and after deductions therefrom as stipulated in its articles of association regarding reserve funds, employee bonus and welfare funds and enterprise development funds, the net profit of an equity joint venture shall be distributed between the equity joint venture partners in proportion to their investment contribution to the enterprise's registered capital."

¹⁰⁷ Article 20 of the PRC Company Law states that "shareholders of a company shall exercise shareholders' rights in accordance with the provisions of laws and administrative regulations and the articles of association of the company and shall not abuse their shareholders' rights to cause damage to the company or the interests of other shareholders or abuse the independent legal person status of the company and limited liability of the shareholders to cause damage to the interests of the creditors of the company."

¹⁰⁸ Article 52 of the PRC Contract Law states that "in any one of the following situations, a contract shall be without effect: (1) one party concludes the contract through the use of fraudulent or coercive means, causing detriment to the interests of the State; (2) the contract involves a malicious conspiracy which is detrimental to the interests of the State, a collective or a third party; (3) illegal intentions are concealed beneath an appearance of legality; (4) there is detriment to social and public interests; or (5) the mandatory provisions of laws and administrative regulations are violated."

¹⁰⁹ The deliberate attempt by the Court in validating the VAM agreement between the investor Haifu and the shareholder Diya was, however, hardly convincing. There was only one VAM agreement in this case (i.e., clause 7.2). The agreement provides that the company shall be obligated to pay the cash compensation. Upon (and only upon) the failure the company in honouring the compensation obligation, the controlling shareholder, Diya, will be obliged to take over the liability. Thus, the agreement between Haifu and Diya was akin to a guarantee agreement for the company's liabilities. The corollary of this analysis is that if the main VAM agreement between Haifu and Shiheng was held to be invalid, the guarantee agreement between Haifu and Diya should be accordingly void. Therefore, in the strict legal sense, the legal consequences (i.e., invalidity) of the main VAM agreement would infect the validity of the guarantee, in which case Diya should not be held to be responsible for a full compensation. On this account,

of Shiheng and its creditors, nor did it violate any provisions of law or regulation, as Diya would compensate the private equity firm, using its own assets. Such agreement reflected the private parties' true intention/undertakings and therefore should be upheld.¹¹⁰

The *Haifu* judgment reflected the then Supreme People's Court's attitude that an investor in a Sino-foreign EJV could enforce a cash-based VAM against the controlling shareholder of the EJV but not against the EJV itself.¹¹¹ Subsequent decisions adopted a similar line of reasoning to hold that VAM agreements between portfolio companies and investors were invalid if there was a violation of creditor rights but VAM agreements between existing shareholders and investors were valid contractual expressions of party autonomy and equal bargaining. 160 out of the 253 investigated VAMs concluded after 2012 made the shareholders of the portfolio company liable under the VAM agreements. Only 22 of the investigated VAMs stipulated that the portfolio company was to bear sole liability under the VAM agreement (See Diagram 5).¹¹²

However, although courts have been observed to follow the principles established in the *Haifu* decision, there is no general principle of *stare decisis* in China and it is unsafe to treat the decision as a black-letter rule in practice as one would in a common law jurisdiction. The case of *Haifu* also lacks even soft binding force as it has not been designated as a guiding case by the Supreme People's Court.¹¹³

Most notably, in the recent case of *Qiang Jingyan v Cao Wubo* (dispute over transfer of equity) (“*Qiang Jingyan*”)¹¹⁴ and the case of *Jiangsu Huagong*¹¹⁵, the Chinese courts took a different

this writer surmises that the Court's holding in this regard was motivated more by the necessity to placate the PE investors that courts are still willing to safeguard their investment interests than by the operation of legal doctrines.

¹¹⁰ As a result, while the Court dismissed *Haifu*'s claim against the company and Ms. Lu Bo, Diya was ordered to perform its obligation under the cash performance ratchet by paying a cash compensation of RMB19,982,095 and court fees to *Haifu*.

¹¹¹ Although court decisions in China do not command the precedential value, in practice, the decisions of the Supreme People's Court of China is almost always deferred to by the lower courts. *Id.*, n. 6.

¹¹² In some cases, there are third party providing guarantee for the bet of making compensation to the investors by the portfolio companies or the shareholders of the portfolio companies.

¹¹³ The *Haifu* case is not a guiding case of the Court, as seen from a perusal of the guiding cases last published by the Court at online: Supreme People's Court <<http://www.court.gov.cn/fabu-gengduo-77.html?page=6>>.

¹¹⁴ *Qiang Jinyan and Cao Wubo Equity Transfer Dispute* (2016) Supreme Court Civil Appeals No. 128, (强静延与曹务波股权转让纠纷案 (2016)最高法民再 128 号).

¹¹⁵ *Jiangsu Huagong Venture Capital Investment Company, Yangzhou Duanya Jichuang Joint Stock Company and Pan Yunhu Request for Share Redemption Dispute* (2019) Suminzai No. 62, 江苏华工创业投资有限公司与扬州锻压机床股份有限公司、潘云虎等请求公司收购股份纠纷案 (2019) 苏民再 62 号.

approach toward VAMs. In *Qiang Jingyan*, the VAM agreement provided for the right of Qiang Jingyan, the investor, to have his shares redeemed by Cao Wubo, the existing shareholder, with the portfolio company undertaking a guarantee with respect to Cao Wubo's obligation on a joint and several basis. Unlike the judgment in *Haifu*, which was underpinned by considerations of creditor protection in accordance with Article 20 of the PRC Company Law, *Qiang Jingyan* based its decision primarily on general principles contained in the requirements of the PRC Contract Law for contracts to be valid, such as the formality requirements under Article 40 and the specific instances where contracts are invalid under Article 52.

Most recently, the principles pronounced in *Haifu* were further shaken by the decision in *Jiangsu Huagong*, where the Higher People's Court of Jiangsu Province ruled that it was Yangzhou Duanya Jichuang Joint Stock Company ("Yangzhou Duanya") that bore liability for the share redemption, recognising that the VAM was entered into with the portfolio company instead of shareholders. The Court held that the Supplementary Agreement containing the VAM was valid and the share redemption provisions under which Yangzhou Duanya was liable did not contravene the mandatory requirements of any law or administrative regulation.¹¹⁶ As a result, the court concluded that the VAM in question did not contravene any mandatory laws or regulations, nor did any ground for contractual invalidity under Article 52 of the Contract law apply. Thus, the VAM was deemed as valid.

The primary reason behind the ruling in *Jiangsu Huagong* is that the PRC Company Law allows share redemption for the purpose of reducing registered capital, provided that the capital reduction is carried out in accordance with legal requirements. Further, when the portfolio company is financially capable of fulfilling its redemption obligations, its assets would remain intact, and the

¹¹⁶ The grounds for the decision are as follows:

1. At the time of signing the VAM, Yangzhou Duanya was a limited liability company, which is not prohibited from repurchasing its own shares under the PRC Company Law.
2. Share buybacks carried out by limited liability companies in accordance with legal requirements do not compromise the principle of capital maintenance or jeopardise creditor interests.
3. The fact that the investor became a shareholder of the company pursuant to the investment does not detract from the investor's prior role as a creditor of the company under the VAM.
4. The VAM was entered into to protect investors interests in view of the specific business risks involved; it was a truthful representation of parties' intentions.
5. Although the returns promised to the investor under the agreement were relatively fixed, they were not substantially higher than the costs of financing during the relevant period. Thus, Yangzhou Duanya did not incur costs or conduct operations in a way that was out of the ordinary course of its business.

claims of its creditors would not be adversely affected. In other words, the key ingredients for a valid share redemption agreement are, first, it has the purpose of capital reduction, and second, it does not compromise the claims of other creditors.

In order to remove judicial uncertainty relating to the legal effectiveness of VAMs, the Supreme Court of China has recently published a conference summaries to guide future judicial practice (“Jiumin Jiyao”).¹¹⁷ The minutes state that when the People’s court is adjudicating disputes involving VAMs, the court should take into account relevant regulations in contract law and Company law. With regards to the VAMs concluded between the investors and the target company, “in the absence of any vitiating factors, when the target company alleges that the VAM is invalid due to share redemption or cash compensation, the People’s Court should not rule that such VAMs are invalid. The People’s Court should examine whether the rule against withdrawal of capital by shareholders, as well as the rule on share redemption in PRC Company Law are complied with.” “When the investor requests the target company to redeem shares, the People’s Court should examine its request according to the requirements listed in Article 35 of the Company Act on the rule against withdrawal of capital by shareholders, or Article 142 on share redemption. If it is found that the target company has failed to meet the relevant requirements, the People’s Court should reject such request.” “When the investor demands monetary compensation from the target company, the People’s Court should examine such demand according to the requirements listed in Article 35 of the Company Law on the rule against withdrawal of capital by shareholders, as well as Article 166 on profit sharing. If it is found that the target company has failed to meet such requirements, the People’s Court should reject such demand from the investor. If the target company has gained profit subsequently, the investor could still initiate litigation against the target company.” Nevertheless these summaries do not have legal effect. The Supreme Court of China should issue judicial interpretations¹¹⁸ and select guiding cases¹¹⁹ to remove judicial uncertainty relating to the legal effectiveness of VAMs.

¹¹⁷ The National Civil Commercial Trial Work Conference -Conference Summary or how the Supreme People’s Court guides the lower courts through issuing conference summaries.

The summaries are available at: <http://www.court.gov.cn/zixun-xiangqing-199691.html>

¹¹⁸ The Supreme People’s Court (SPC) has been issuing judicial interpretations to fill legislative gap. On judicial interpretation, see further in Li Wei, *Judicial Interpretation In China*, 5 (1) *Willamette Journal of International Law and Dispute Resolution* 87 (1997)

¹¹⁹ In November 2010, the Supreme People’s Court of China (the “SPC”) established the Case Guidance System, a system in which certain Chinese court judgments are selected and re-issued as de facto binding Guiding Cases to guide the adjudication of similar subsequent cases and ensure the uniform application of law. For further information relating to the guiding case, see <https://cgc.law.stanford.edu/about-the-cgcp/>

4. Ways Forward

Legal reform is needed to address the concerns discussed above and to facilitate venture finance contracting in China by equipping investors with the appropriate sword and shield in their arsenal such that VAM can be eventually replaced. These include (1) relaxing the restrictions in company law on the issuing of financial instruments such as the convertible preferred stock and convertible bonds to *empower* investors, and (2) introducing more legal remedies for minority investors, such as introducing oppression remedies, clarifying the scope and standard of fiduciary duties of directors, as well as relaxing the rules on derivative actions, to *protect* investors.¹²⁰ Admittedly, across-the-board legal reform may be costlier than ad-hoc private ordering, but the key advantages to legal reforms lie not in their short-term cost effectiveness, but their long-term potential in establishing a healthier venture capitalists-entrepreneur relationship. It is beyond the scope of the paper to discuss legal reform on minority protection. This part instead focuses on the theoretical benefits to investor-entrepreneur dynamics by introducing convertible preferred stock¹²¹ for China's venture capital market and the practical difficulties in doing so.

Empirical studies show that convertible preferred stock have long been the most common form of security issued in venture capital financing rounds.¹²² Apart from the above discussion on how convertible preferred stock responds to some of the concerns that investors address by using VAMs, economic literature has also showed that convertible preferred stock efficiently (1) aligns the incentives of entrepreneurs and venture capitalists,¹²³ (2) allocates control between the investor and entrepreneur, (3) signal the entrepreneur's talent and motivation,¹²⁴ and (4) discourage entrepreneurs from engaging in "window dressing" in order to induce the venture capitalists to

¹²⁰ It is beyond the scope of this article to discuss these issues.

¹²¹ Part 2 of this article also discusses the problems of the lack of convertible proffered stock in China.

¹²² In a 2002 study, it was found that out of 213 venture capital financing rounds in 119 portfolio companies by 14 different venture capital firms, 170 of them comprised the issuance of convertible preferred stock only, and 202 of them were issuances of convertible preferred stock and some other security such as straight preferred stock and common stock. Steven N. Kaplan and Per Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 *REVIEW OF ECO.STU.* 281 (2003).

¹²³ Klaus M. Schmidt, *Convertible Securities and Venture Capital Finance*, 58(3) *J. of Finance* 1139 (2003).

¹²⁴ Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 *HARV. L. REV.* 874 (2003) at 875.

participate in further rounds of financing.¹²⁵ Depending on the particular jurisdiction in which the convertible preferred stock is used, there may be other unique advantages to this financing instrument, such as reduction in the tax burden on managers' incentive compensation under unique US tax law.¹²⁶

Take the alignment of interests for example. Schmidt notes in this regard that “the ultimate success of high-potential, entrepreneurial firms does not only depend on the quality of the project (but) also the effort provided by the entrepreneur (and) the commitment of the venture capitalists.”¹²⁷ The problem, however, lies with devising a system of remuneration that properly aligns the interests of both entrepreneur and the venture capitalists. Many consider vanilla equity financing to be untenable as it leads to the “double moral hazard problem” between the entrepreneur and the venture capitalists, where each contributes less and takes on more risks because they assume that the other party bears the costs of such actions.¹²⁸ In this regard, theoretical models constructed by Gompers¹²⁹ and Schmidt¹³⁰ show that convertible preferred stock outshines straight debt or equity as the security of choice in venture capital financing. As explained by Gompers,¹³¹ “the convertible preferred security can act as both an incentive compensation system for the entrepreneur (because he shares substantially in the upside of the firm but does not benefit from increasing risk) and as a screening mechanism (because the downside discipline of the preferred debt portion makes the deal unattractive to low quality entrepreneur)”.

Another function of convertible preferred stock is in reducing “window dressing” by entrepreneurs. “Window dressing” is a form of signal manipulation which may occur at the start of each new financing round.¹³² It refers to attempts by an entrepreneur to improve short-term financial performance at the expense of long-term value creation in order to ensure that the project will be refinanced by new or existing investors and to avoid the possible liquidation of the venture. Where

¹²⁵ Francesca Cornelli and Oved Yosha, Stage Financing and the Role of Convertible Debt, 70(1) THE REV. OF ECO. STU.1 (2003).

¹²⁶ Supra note 124.

¹²⁷ Klaus M. Schmidt, supra note 123 at 1.

¹²⁸ Id at 2. See also Richard C. Green, Investment Incentives, Debt, and Warrants 13 J. of Financial Eco 115 (1984); Paul A. Gompers, Ownership and Control in Entrepreneurial Firms: An Examination of Convertible Securities in Venture Capital Investments, <http://www.people.hbs.edu/pgompers/convert.pdf> (last visited on July 3, 2019).

¹²⁹ Gompers, supra note 6.

¹³⁰ Schmidt, supra note 2.

¹³¹ Gompers, supra note 6.

¹³² Cornelli, Francesca and Yosha, Oved, Stage Financing and the Role of Convertible Debt (August 1997). London Business School Working Paper No. 253-1997 . Available at SSRN: <https://ssrn.com/abstract=48581> or <http://dx.doi.org/10.2139/ssrn.48581>

convertible preferred stock is used, any attempt to engage in “window dressing” simultaneously increases the possibility that existing investors may decide to exercise their options to convert, thus significantly reducing the equity stake of the entrepreneur. Hence, convertible preferred stock may effectively deter such practices. The model constructed by Corneli and Yosha shows that where convertible securities are adopted, the entrepreneur will not engage in signal manipulation.

Moreover, it has been argued that convertible preferred stock may be useful in allocating control in a manner that is contingent on the performance of the portfolio company. This can be achieved through contractual arrangements that provide for the contingent shifting of control rights upon the occurrence of certain financial events, (e.g., if EBIT¹³³ falls below a specified level).

The allocation of control rights through convertible securities was examined by Thomas Hellmann in the context of exit decisions.¹³⁴ According to Hellmann’s model, the power to make the exit decision should lie with the entrepreneur when the potential success of the venture is high; otherwise, it should lie with the venture capitalists. This may be because each party holds different preferences as to the form of exit (venture capitalists prefer exit by acquisition, whereas entrepreneurs prefer IPOs).¹³⁵

That convertible preferred stock establishes an investor-entrepreneur relationship with greater mutual trust, interest alignment and sustainability is apparent from the above discussion. If introduced, Chinese investors will have access to an alternative financing instrument to protect their interests and not have to rely solely on VAMs. However, as discussed in Part 2, Chinese law does not provide for preferred stock for limited liability companies. In these circumstances, any attempt to create convertible preferred stock for limited liability companies becomes a purely contractual endeavour, making the characteristics and terms of such shares heavily dependent on private negotiations and provisions. Further, this means that provisions on preferred stock need to be cleaned before such companies go public, resulting in a somewhat forced conversion into

¹³³ Earnings before interest and taxes.

¹³⁴ Hellmann, Thomas F., Ipos, Acquisitions and the Use of Convertible Securities in Venture Capital. Sauder School of Business Working Paper. Available at SSRN: <https://ssrn.com/abstract=257608>. or <http://dx.doi.org/10.2139/ssrn.257608>; See also, Erik Berglöf, A Control Theory of Venture Capital Finance, J.L. ECON. & ORG. 247, 248 (1994).

¹³⁵ Id.

ordinary shares.¹³⁶ The result of this is that all the potential benefits from the use of convertible preferred stock as analysed above would be heavily discounted in Chinese parties' half-hearted endeavours to contractually "recreate" convertible preferred stock while working around legal difficulties.

As to why Chinese law remains cautious about convertible preferred stock, there are a few potential explanations. First, preferred stock, if introduced, will be a new form of financing instrument in China; the inexperience of investors with it, if coupled with insufficient regulatory oversight, may lead to disastrous consequences. Further, a reported reason is that legislators are wary of the potential conflict of interests among different classes of shareholders if preferred stock is introduced. As the main participants of Chinese stock markets are individual retail investors,¹³⁷ there may be a worry that convertible preferred shareholders will compromise the interests of common shareholders; for example, conversion of preferred stock into common stock may lead to a decrease in the price of common stock on secondary markets. These concerns caused a strong backlash against the introduction of convertible preferred stock when the Pilot Measures on Preferred Stock were rolled out in 2014.¹³⁸ However, the percentage of small retail investors in the A-share markets has considerably decreased over the last few years.¹³⁹ Considering also the need to conform with international best practices, facilitate venture capital financing and answer to the needs of start-up firms, there may be a stronger justification for introducing the flexible and useful financing tool that is convertible preferred stock.

¹³⁶ Interview with Ms Zou Jing, a partner of Grandall Law Office in Shanghai on April 22, 2019.

¹³⁷ The percentage of individual retail investors in the public float of the Chinese A-share markets has reached 72% in 2014. See Zhong Jin Corporation: Percentage of Retail Investors in A-share Market Showing Considerable Decrease, <https://m.21jingji.com/article/20190702/herald/b39f0f661609f2353cdfafbb8d88b974.html>

¹³⁸ During the public consultation process leading to the promulgation of the State Council Opinions 《国务院关于开展优先股试点的指导意见》, 429 comments were made in reference to Article 33 on convertible preferred stock in the draft Opinions. Among these, 427 were from retail investors, sharing the sentiment that convertible preferred stock may create the same problem as the non-tradable share reforms, squeezing out common shareholders and causing share prices in secondary markets to plummet. Some retail investors suggested a ban on conversion or a longer lock-out period during which conversion is prohibited. See CSRC, Measures for the Administration of the Pilot Program of Preferred Shares 《优先股试点管理办法》, 21 March 2014, available at <http://www.csrc.gov.cn/pub/newsite/zjhxwFB/xwDD/201403/t20140321_245901.html>.

¹³⁹ By estimation, the percentage of retail shareholding in the overall market capitalisation has decreased from 28% in 2014 to 21% in 2018. Further, the percentage of retail shareholding in the public float has decreased from 72% in 2014 to 53% in 2018. This change in shareholding profile demonstrates a considerable decrease in the "retailisation" (散户化) of A-share markets. See Zhong Jin Corporation: Percentage of Retail Investors in A-share Market Showing Considerable Decrease <https://m.21jingji.com/article/20190702/herald/b39f0f661609f2353cdfafbb8d88b974.html>

Policy maker may consider first allowing listed companies to issue convertible preferred stock.¹⁴⁰ Moreover, notable developments in China's new Nasdaq-style tech innovation board (the STAR Board) that focuses on tech companies¹⁴¹ may cause regulators to face heads-on the issue of convertible preferred stock used by these essentially foreign entities. However, there is no clear consensus on how exactly this will turn out. Similarly, to the extent that the new board is testing out dual class shares, such experiments seem to focus on voting rights and thus the position with respect to conversion rights remains unknown.¹⁴² It is suggested that legislative measures be expedited to formally acknowledge convertible preferred stock to bring China in conformity with international standard practice.

One of the principal issues that comes with the introduction of convertible preferred stock, as discussed by Bratton,¹⁴³ is the risk of abuse by a distinct group of corporate controllers, namely preferred shareholders or investors, and whether this group should owe fiduciary duties vis-à-vis other shareholders and/or the portfolio company. Case law in some US states stands for the propositions that such duties should be owed.¹⁴⁴ However, no such duties are owed by major/controlling shareholders under Chinese law.¹⁴⁵ Therefore, if China introduces convertible preferred stock, there will also be a need to introduce fiduciary duties owed by controlling shareholders so as to prevent abuse of convertible preferred stock. However, US law that imposes fiduciary duties on controlling shareholders cannot simply be transplanted to civil law China

¹⁴⁰ Indeed, Chinese regulators have become more liberal on this issue. The CSRC has recently amended the old Guiding Opinions of the China Banking Regulatory Commission and the China Securities Regulatory Commission on Commercial Banks Offering Preferred Shares to Replenish Tier 1 《中国银监会 中国证监会关于商业银行发行优先股补充一级资本的指导意见》 Capital (Yin Jianfa No. 12 [2014] of the China Banking Regulatory Commission). Issued in 2019, the new Guiding Opinions of the China Banking Regulatory Commission and the China Securities Regulatory Commission on Commercial Banks Offering Preferred Shares to Replenish Tier 1 Capital (Amended) 《中国银保监会 中国证监会关于商业银行发行优先股补充一级资本的指导意见（修订）》 (provides that non-listed banks can on their own motion issue preferred stock if certain conditions are met.

¹⁴¹ China Finalises Rules for New Technology Exchange in Shanghai, Bloomberg News (2019), <https://www.bloomberg.com/news/articles/2019-03-02/china-finalizes-rules-for-new-technology-exchange-in-shanghai> (last visited July 3, 2019).

¹⁴² Why Shanghai's New Nasdaq-style Tech Board may be a Game Changer, The Straits Times (2019), <https://www.straitstimes.com/business/companies-markets/why-shanghais-new-nasdaq-style-tech-board-may-be-a-game-changer-0> last visited 3 July 2019.

¹⁴³ Supra note 61.

¹⁴⁴ Id. at 1876.

¹⁴⁵ Although Article 63 of the Code has provisions for the fiduciary duties that a controlling shareholder of a listed company owes to the company and other shareholders, the Code itself is not legally binding and cannot be enforced by the court. See supra note 87. See also, Lin Lin, "[Code of Corporate Governance: Lessons from Singapore to China](#)" (2019) 40(7) *Company Lawyer* 227-236.

without analyzing how such duties cohere with and are justified by the distinctive legal doctrines in China.

It is out of the scope of this article to examine how to subject controllers to fiduciary duties in China. Currently, controlling shareholders¹⁴⁶ are not subject to any fiduciary duties under PRC Company law. However, Article 20 of the PRC Company Law¹⁴⁷ provides that controlling shareholders shall not abuse their power to the detriment of the company and other shareholders. Controlling shareholders who do so and result in harm to the company and other shareholders are liable for compensation. On the face of it, this duty appears to be similar to fiduciary duties owed by controlling shareholders under American company law and may provide some reprieve against them. However, these provisions are nevertheless too general and simplistic to shed any meaningful light on the law's substantive expectations of controlling shareholders' conduct. Further, there is also no guidance as to how Article 20 can be invoked.

Moreover, there are difficulties in imposing controlling shareholders' duties in China. It heavily relies on the interpretation by courts. As a civil law country without *stare decisis*, it will be difficult to enforce such duties unless all the Chinese courts are competent enough to appreciate the rationale, scope and proper application of this fiduciary duty. Nevertheless, this is not an insurmountable problem and the Supreme People's Court may consider issuing judicial interpretations to solve this problem.

Further, there is unsolved theoretical debate between contract law and fiduciary law in the context of preferred stock.¹⁴⁸ In particular, the question of whether fiduciary law protects a common stock

¹⁴⁶ Part 2 of Article 216 of the PRC Company Law defines a "controlling shareholder" as a shareholder whose capital contribution occupies 50% or more in the total capital of a limited liability company or a shareholder whose stock occupies more than 50% of the total equity stock of a joint stock limited company or a shareholder whose capital contribution or proportion of stock is less than 50% but who enjoys a voting right according to its capital contribution or the stock it holds is large enough to impose an big impact upon the resolution of the shareholders' meeting or the shareholders' assembly.

¹⁴⁷ The text of Article 20 of the PRC Company Law reads: the shareholders of a company shall abide by the laws, administrative regulations and bylaw and shall exercise the shareholder's rights under the law. None of them may injure any of the interests of the company or of other shareholders by abusing the shareholder's rights, or injure the interests of any creditor of the company by abusing the independent status of legal person or the shareholder's limited liabilities. Where any of the shareholders of a company causes any loss to the company or to other shareholders by abusing the shareholder's rights, it shall be liable for compensation. Where any of the shareholders of a company evades the payment of its debts by abusing the independent status of legal person or the shareholder's limited liabilities, if it seriously injures the interests of any creditor, it shall bear several and joint liabilities for the debts of the company.

¹⁴⁸ *Supra* note 61.

minority when a preferred stockholder in control exercises its contract rights to impair the common's interest is still a controversial issue under US law.¹⁴⁹ Under US law and legal literature, there are three prevailing views:¹⁵⁰ the first takes contract seriously by arguing that preferred stockholders should not be bound by such additional duties because common stockholders have already consented to them exercising the rights that preferred shareholders have bargained for. The other extreme takes corporate law seriously by imposing an intrinsic fairness review on exercise of contractual rights by preferred stockholders' vis-à-vis common shareholders' interests in both shareholder decision-making and boardroom actions by investor-appointed directors, as represented by the Delaware case of *In re Trados Inc. Shareholder Litigation*.¹⁵¹ The third view, advocated by Bratton, takes a middle position by arguing that there is a need for some form of fiduciary duty and decision review, but that such a review should take place on the narrower ground of whether the decision is in good faith. As Delaware law currently stands, the strict standard review applies, but the academic controversy relating to the matter brings up fundamental issues of the theory behind preferred stock, which are definitely salient if China wishes to fully embrace the concept.

In addition, if Gilson and Schizer were right about the tax advantages being determinative of the popularity of convertible preferred stock in the US, introducing convertible preferred stock in China per se without revamping China's tax laws may not capture its whole benefits as materialized in the US market, especially also considering the transaction costs that may come with understanding and negotiating a brand-new contracting device. Existing comparative case studies include Canada, where, as found by Cumming, convertible preferred stock is less used as compared to the US in venture capital deals.¹⁵² The author's conversation with Indian lawyers also showed that Indian investors use convertible preferred stock or put option in venture financing.¹⁵³

¹⁴⁹ *Id.* at 1875.

¹⁵⁰ *Id.* at 1877-1879.

¹⁵¹ Civ. A. No. 1512-CC, 2009 WL 2225958 (Del. Ch. July 24, 2009).

¹⁵² See Douglas J. Cumming, *United States Venture Capital Financial Contracting: Evidence from Investments in Foreign Securities 2* (2002) (unpublished manuscript, on file with the Harvard Law School Library), available at <http://hal-web.usc.edu/cleo/ALEA/cumming.pdf> (noting that convertible securities are not the most commonly used capital structure for American venture capital in Canada). See also Ronald J. Gilson & David M. Schizer, *supra* note 124.

¹⁵³ *Id.*

5. Conclusion

The article advances an understanding of the unique features of Chinese venture capital contracting, as compared to its US counterpart. The main feature of Chinese venture capital practice is the prevalence of VAMs in investment agreements, which are not commonly found in their American counterparts. This paper argues that unlike American venture capital contracts, the underlying principles of which are to incentivize all parties and to apply as a universal and long-term paradigm,¹⁵⁴ VAMs are an *ad-hoc* solution created to address the serious investor protection problem in the transitional and less informed Chinese market. Hence, while it may appear desirable to parties, it is merely a stopgap that serves as an imperfect and less desired contracting design in venture capital investments.

The article also contributes to the existing literature on contractual innovation in the context of venture capital practice. While Coyle and Green predict that the following groups are most likely to develop a lasting contractual innovation: (1) contract users, (2) high-volume intermediaries such as law firms, and (3) trade associations,¹⁵⁵ this article shows that contract users are the real instigators of innovation by lawyers. The interviewed investors and lawyers, who have a great stake amidst inadequate legal protection and high risks in an immature market, are not willing to sit back and let lawyers be their delegates.¹⁵⁶ Instead, investors have actively promulgated norms and formed a strong driving force behind the creation and prevalence of VAMs.¹⁵⁷

Finally, this article has implications for the debate concerning legal transplantation of contractual terms from the US to a less mature and informed market. There are various contextual considerations in transplanting well-established contractual terms from the US to China, such as the lack of various investment tools and the legal restrictions in the Company Law, the lack of effective protection of investors by law, and the presence of less experienced and sophisticated venture capitalists and entrepreneurs in China.¹⁵⁸ These conditions are likely to be fatal to any attempted transplantation of the common contractual terms used in the US venture capital sector.

¹⁵⁴ See Ronald J. Gilson, *supra* note 1.

¹⁵⁵ *Supra* note 16, at 141.

¹⁵⁶ Interview, Mr. Zhang Jun, Partner, Han Kun Law Office, Beijing, 26 October 2019. Interview, official, AMAC, Office, Beijing, 26 October 2019. Interview, Mr. Dong Hao, Partner, Deheng Law office, Chongqing, 24 October 2019.

¹⁵⁷ This is also confirmed by the author's interviews with practitioners. See *supra* note 8 for the list of interviewees.

¹⁵⁸ See *supra* note 18.

Arguably, these contextual considerations can be gradually solved with market evolution, such as the increased sophistication of the venture capital communities and the increased effectiveness of reputation mechanism. They can, however, also be solved by law reforms including improving minority protection, relaxing the rules on investment tools and improving the national credit system. When parties finally feel sufficiently protected and confident about each other's *bona fides* going into a deal, that is when the need for VAMs no longer arises and the Chinese venture capital market can march into sustainable development.