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Valuation Adjustment Mechanismsin Private Equity: Enforceability, Risk Allocation, and Dispute Resolution

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Abstract. Valuation Adjustment Mechanisms (VAMs) come with many questions as to their enforceability, risk allocation and means of dispute-resolution under the current regulatory frameworks for private equity investments. The study dissects how the risk is allocated between the investors and the portfolio companies, key contractual features and maps the practical dispute-resolution routes by analysing selected case studies and a relevant regulatory guidance. The paper also recommends clause designs for the actionable sections of the paper and due diligence checklist for equity investments for better risk management and compliance. The results shed light on the design decisions of VAMs in the context of regulatory development, point out some of the typical challenges in terms of enforceability, and provide practical recommendations to practitioners, investors and regulators. The contribution is in the idea and the execution of connecting theory and practice, turning regulatory understanding into drafting guidance and due-diligence processes, and thus improving clarity, predictability and resilience in PE transactions.

Keywords: Valuation Adjustment Mechanism (VAMs), Private Equity, Enforceability, Risk Allocation, Dispute Resolution

1. Introduction

1.1. Background

For many years, a key risk mitigation mechanism used in private equity (PE) investments has been the "Valuation Adjustment Mechanisms" (VAMs) in which PE companies commit themselves to delivering a specific performance objective within a prescribed timeframe or to IPOing. The Haifu Investment decision, which set the lower limit of enforceability and legitimacy of VAMs contractually, sparked the academic and institutional debate on the effectiveness of VAMs. But the macro-regulatory attitude has dramatically changed since, even though VAMs friction has increased. This trajectory has gradually shifted from the complete invalidation of the VAMs in the Haifu ruling to the crackdown on the micro-prudential rules, such as the Regulatory Rules Application Guidelines: Issuance Category No. 4 issued by the China Securities Regulatory Commission (CSRC) and the Measures for the Administration of Equity Investment of Insurance Companies issued by the National Financial Regulatory Administration (NFRA) (in effect for 2024). These regulations actually limit opportunistic "side agreements," such as IPO linked "ratchets" and debt

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disguised equity. However, VAMs have long been entrenched in financing arrangements and debates about the practice of VAMs, their best design and their effectiveness in structures continue [1].

The contractual design of VAMs is complex and cuts across financial engineering and corporate governance, as well as challenging legal, accounting and cash-flow allocation aspects. VAMs provisions which lead to negative externalities and expropriation from non-participating investors should be carefully controlled from optimal contracting point of view. At the same time, there are some operational covenants that are necessary to prevent information asymmetry and insider moral hazard that may lead to tunnelings that impair collective investor returns and shareholder value. In the context of increasing regulatory oversight, the design of VAMs is a trade-off between the enforceability of institutions and risk allocation which is still very controversial. Therefore, this paper examines the structural position of VAMs, the conditions of their activities, and the activities that follow in the context of conflict resolution

1.2. Problem Statement

Valuation Adjustment Mechanisms (VAMs) are a generic risk-mitigation feature of equity financing, in which the terms of the contracts provide for various event- or performance-based triggers. While some restrictive covenants address the risk-return imbalance arising from information asymmetry between investors and entrepreneurs, it is often the case that these restrictive covenants are asymmetrically distributed with respect to rights and obligations, and, as such, are subject to heated contract-validity conflicts due to the potential expropriation of wealth from other parties [2]. In addition, handling conflicts in VAMs is very difficult. In a dispute resolution process, formal litigation is all too often synonymous with lengthy judicial cycles. This can easily lead to significant reputational harm to portfolio companies and lost opportunities to enter the market, and to an unquantifiable loss of capital for investors and investees alike to the extent that the prolonged litigation results in a loss.

2. VAMs as a binding force and enforceable document

2.1. The legal nature of VAMs is discussed in this section

The Valuation Adjustment Mechanism (VAMs) has been broadly adopted in international private equity practice as a mechanism derived from option-based structures in overseas capital markets that seeks to resolve the valuation disparity that is created by information asymmetry issues between investors and investees. Later, foreign private equity firms brought this system to the Chinese market to deal with valuation issues that are inherent in Chinese corporate governance. As a risk-sharing mechanism, the mechanism is effective in reducing the transaction uncertainty, and it is especially used to encourage underperforming target companies to improve their operational performance during a short period of time by using a "binary payoff" structure [3].

Although there is no explicit statutory regulation on private equity VAMs in Chinese statutory law, there is still a high uncertainty whether this is valid in practice. In the judicial realm, the dichotomy between the validity of VAMs depending on different contracting parties gives the rationale behind the distinction between the rights and obligations of investors, portfolio companies and their controlling shareholders. It is on this basis that the VAMs are thought of as conditional contracts and not as pure aleatory contracts.

For now, regulators reject covenants which are in direct violation of the principle of capital maintenance or that take away the legitimate interests of external corporate creditors. "Side

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agreements" that attempt to circumvent the statutory corporate buy back or compensation are routinely struck down, especially during the judicial revolution that was initiated by the Haifu case. Moreover, judicial views have gradually moved away from the first categorical denial of contractual validity to a doctrine of "separating validity from performance [4]. Yet, even if equity buy-backs were made compulsory with statutory capital reduction procedures, in practice this would still present significant difficulties for their actual implementation. This mechanical entanglement has a significant impact on the exercise of private rational choice in optimal contracting and exacerbates the institutional conflict between financial innovation and inflexible regulation. These institutional constraints force the market actors to develop more covert forms of compensation in subsequent contract designs, creating a multiplying problem of complicated legal compliance and judicial enforcement.

2.2. The investor will need to write a check to the OSSF (original shareholders/founders) in order to purchase their shares

Judicial practice has evolved a different recognition of the validity of VAMs, depending on the contracting parties, to give equal rights and obligations to those parties. Courts tend to recognize the absolute validity of a VAMs agreement executed between the investor and the original shareholders/founders (also referred to as a "Horizontal VAMs") [5]. This is to respect the principle of privity of contract and the freedom of contract. Since the compensation or share repurchase is completely from the founder's personal funds, it doesn't use up anything from the company's assets. Hence it does not affect the interest of external creditors of the company. In such cases, it is easy to enforce the VAMs, as long as the founders have personal solvency.

2.3. The investor firm purchases the target firm's shares in order to take control of it

However, the linkage of the equity repurchases with the statutory capital reduction procedure is still a huge hurdle in practice for contract fulfillment. A capital reduction in the case of China calls for a two-thirds vote of the shareholders' meeting and stipulation of public notification period for creditors, who will have the right to require immediate debt repayment or additional guarantees.

In a typical dispute scenario, founders – who generally also control the board and shareholders' meeting – will methodically vote against the resolution on a capital reduction, thereby causing a deadlock in the company that can never be resolved. The company may not have enough money to repay creditors, even if the resolution is successful, who may want their money back immediately. This linking of the enforceability of the contract directly to the corporate capital reduction procedures is objectively the limitation of privately rational contractual freedom. It heightens the structural tensions between financial innovation and inflexible regulations.

Traditionally, Chinese courts have been very stringent on this question. As reflected by the judicial development since the Haifu case (2012), the initial judicial trend was that any VAMs that required the target company to pay compensation to investors had an intrinsic impact on the integrity of the company's assets and the interests of creditors and therefore the agreements could be completely invalidated [6]. The rationale behind this was quite traditional based on the capital maintenance doctrine that would not allow the shareholders to withdraw the capital given so as to maintain a stable asset cushion for the creditors. This hard line approach resulted in the "drawer agreements" (side letters) used to circumvent the statutory corporate procedures for share repurchases or financial compensation being routinely struck down [7].

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The strictness of the Chinese statutory requirements makes it very difficult, if not impossible, to practically implement the Vertical VAMs, in contrast to other jurisdictions such as Delaware in the United States where a more flexible "surplus test" (which provides for repurchase as long as the company's net assets are surplus to its capital) is adopted [8]. As a result, in subsequent contract designs, market players are forced to use more camouflage financial compensation structures. Investors may choose to engage in sophisticated offshore structures, or use disguised forms of debt instruments, to evade capital reduction restrictions and create a more complicated dual "legal/compliance and judicial/enforcement" problem. The strictness of the procedures ultimately means that the VAMs can become more of a paper promise, than a risk-hedging tool.

3. Risk allocation mechanisms in VAMs

The most basic understanding of a Valuation Adjustment Mechanism (VAMs) from a law and economics perspective is that it is an ex post pricing adjustment mechanism. But sometimes, the theory of risk allocation is not consistent with the reality of corporate governance, with unintended consequences.

3.1. Bridging the valuation gap

Valuation gap between investors and founders is an inherent problem in the world of private equity and venture capital. Founders have a lot of inside information and are optimistic about their business and they are going to push for high valuations. However, the investors are under extreme information asymmetry and the uncertainties of the market and they want protection against downside. VAMs are a contractual mechanism for bridging this gap by changing a one-time upfront valuation to a dynamic continuum based on performance.

For this, VAMs use a number of triggers which assign future risks to the party best able to manage them. Financial triggers are typically used to cover operational execution risks, and are based on having reached a certain net profit margin, revenue growth target, or EBITDA target [9]. These are similar to "earn-out" clauses that are common in M&A transactions in the west. Non-financial triggers, on the other hand, are gaining greater application with regard to systematic or strategic risks. The most common non-financial trigger is the fixed deadline for an Initial Public Offering (IPO) moving the liquidity risk from the investor to the founder. Non-financial targets can be such things as achieving milestones regarding users or securing key patents or regulatory approvals. VAMs supposedly make the interests of both parties converge by tying the final equity ratio or cash paid to these contingent events.

3.2. The imbalance of risk

VAMs' practical implementation often leads to an extremely skewed balance of risk, which essentially undermines corporate governance and increases agency costs.

One of the biggest weaknesses of the traditional VAMs design is setting performance targets at too low a level and setting them against a binary threshold [10]. The founders get highly motivated to take short-term and aggressive business decisions when they are on the verge of giving up the control of their company or incur a huge personal liability on failing to meet a target. Founders may make drastic cuts on critical long-term investments like Research and Development (R&D) or employee training, in order to meet strict financial requirements. At the extreme end, the pressure of a VAMs can cause moral hazard, causing financial statements to be manipulated or expansionary

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actions to be taken. Therefore, the VAMs create greater operational and compliance risk for the target company, while also creating greater long-term risk for the long-term shareholders, but it does not actually mitigate the risk.

Asymmetry in Information vs. Control: Also, VAMs may not lead to a true risk hedging because of the basic asymmetry of capital and control. Investors have capital advantage and in most cases, do not have day-to-day management. Founders, even though they are limited in capital, have absolute control over day to day operations and have monopoly of information inside the company. This is a huge issue when a VAMs is triggered. When the founders believe they are not going to meet the numbers, they may intentionally hide bad news, plunder assets from the company or do "related party" deals prior to the investor's repurchase opportunity. When the investor decides to exercise the VAMs, the target company is usually a "shell" [11]. Thus, the VAMs, which are supposed to be a tool for the protection of the investor, ironically puts him in a vulnerable situation with the ultimate residual risk of the failure of the company he invests in.

3.3. Optimal risk allocation

It is crucial to re-imagine the VAMs in order to capture a more equitable and optimal risk allocation model and halt the drift towards destructive zero-sum games. The focus should be on moving away from punishment towards mutually rewarding incentive systems.

First, Grace Periods should be part of the standard drafting practice. Macroeconomics, regulatory changes or force majeure events – like the current global pandemic – can have a big impact on startups. It is economically irrational to have a rigid VAMs with an immediate default in such situations. The grace period or "material adverse change" (MAC) clause provides some breathing room for founders to deal with external shocks without being immediately subject to liquidation or a hostile takeover.

Secondly, binary "all-or-nothing" triggers ("cliff" triggers) should be substituted with Tiered Targets (Step-up/Step-down mechanisms) A tiered VAMs works like a sliding scale that takes into account the percentage of the target that was actually met, instead of hitting a devastating penalty if it falls just short of a target [12]. This proportional adjustment keeps the motivation of the founders in place even if the top target is no longer achievable, so as to reduce the risk of "short term thinking" [13] .

Lastly, Symmetric Risk Sharing is needed for optimal risk allocation. An investor should be aware that investing in VC is associated with risks and VAMs are not able to give absolute assurance of preservation of capital. Limiting founders' liability to their stake in the target company, up to a maximum amount and not their entire wealth reduces the moral hazard (extreme moral hazard is limiting it to founders' equity stake in the target company, as this means founders can get out of the jurisdiction). VAMs can do their real economic job of aligning incentives by setting up rational, tiered and bounded risk-sharing models.

4. Dispute resolution in VAMs agreements

Valuation Adjustment Mechanisms Disputes seldom come out of thin air but are usually spurred by certain contractual defaults that have a fundamental effect on the investor's exit strategy or return on investment. In fact, these conflicts are mostly sparked by three types of triggering events:

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4.1. Common triggers for disputes

Failure to achieve an IPO: The most common trigger for VAMs disputes is when the business fails to go public (Initial Public Offering or "IPO") or to sell the business to a qualified trade purchaser within a very specific timeframe. An IPO is the ultimate in terms of a liquidity event for private equity investors. If the investment-period is over, the investor's right to require a share repurchase is automatically triggered. But conflicts often occur because the success of IPOs is seldom fully up to the founders. Often, the founder will say that there was some external factor that caused the failure – for example, sudden changes in the policy of a securities commission or a macro-economic slowdown or a closed IPO window – that would give rise to force majeure or a doctrine of frustration of purpose. Investors, on the other hand, are usually very demanding about the absolute strictness of the VAMs deadline and so there are often very aggressive legal disputes on the allocation of external systemic risks.

Failure to Meet Performance Targets – One of the common areas of VAMs litigation is financial triggers – targets for net profit or revenue that haven't been met. These types of conflicts are technical in nature and tend to focus on the accounting method used and not just on a failure to operate. Founders may contend that the companies that were originally the targets were not commercially viable, or that circumstances beyond the company's control caused problems. More often, however, bitter conflicts arise over the auditing process itself. Investors might allege that founders "managed earnings" (e.g., delayed expenses or made up sales) to meet the targets, or that the auditor was not independent or that different accounting rules were used to arrive at the actual EBITDA or net profit.

Other Risk Events: Financial Fraud & Executive Scandals In addition to commercial metrics, "bad boy clauses" or Material Adverse Change (MAC) triggers have come to be used in modern VAMs as a safeguard for investors against critical integrity and compliance risks [1]. When financial fraud is discovered or when there is extreme lack of compliance with the operation, it becomes an essential violation of representation and warranties, and a loss of confidence between capital and management. Moreover, scandals (criminal investigations, moral turpitude, major public relations crisis, etc.) concerning the founder or key executives can cause devastating reputational harm, and immediately result in a drop in the company's valuation. When such events happen, investors tend to sell the securities with accelerated repurchase demands which are basically to immediately recover their invested capital. Here conflicts can be the most fierce, with claims of tortious fraud as well as breach of contract and often resulting in investors seeking aggressive asset preservation actions against the personal assets of the founders.

4.2. Litigation vs. arbitration

Arbitration and mediation are often the preferred standard methods for resolving VAMs disputes in private equity (PE) investments as they are confidential, have professional expertise, and are structurally flexible. This creates a mediation mechanism with industry professionals, which then help the investors and entrepreneurs to reach out to negotiated flexible equity buy-back schemes. Hence, it reduces the costs of disruption associated with formal court judgements and stops buy-backs becoming a cash-flow crisis, when they have to be done immediately, and the portfolio company is driven into financial distress or bankruptcy. Such flexible dispute resolution channels allow, at the same time, the protection of the continuity of the enterprise and the settlement of the capital claims of the investors in sequence.

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4.3. Challenges in enforcement

One of the common issues in VAMs dispute resolution is the "pyrrhic victory" [6] which is a victory in court but not in the enforcement of the judgment. Litigation is a lengthy process that typically involves long trials, appeals and jurisdictional challenges. This time cost can be fatal to target companies – typically startups or growth stage businesses. Firstly, a public lawsuit can have a serious negative impact on the reputation and creditworthiness of the target company which can result in a liquidity crisis as a subsequent financing source is suddenly pulled.

On the other hand, investor actions to preserve investments can lock up the running of the company's business from the get-go – putting bank accounts on hold or seizing central assets. That is, throughout the legal proceedings, the target firm's business value is fully extracted. If it is finally determined that it is favourable, the target company is typically very insolvent and there is nothing to execute. It is a bitter reality that makes the share repurchase clause—hoped to be a protective measure in case of a downturn—now unenforceable paper judgments as it is to no effect at all for the VAMs to mitigate risk.

5. Recommendations for practice and regulation

5.1. Drafting better VAMs clauses

The contractual arrangements should define the basic risk bearing matrix with a "triggering conditions - compensation ratios - stepped compliance" format [1], making sure the compensation mechanism is consistent with the business size and risk bearing capacity of the firm. On this basis, investors and entrepreneurs can agree contingent and flexible compensation schemes, depending on the real performance of the firm and its financial situation. This allows for staggered implementation of buy-back covenants and avoids "one-size-fits-all" compulsory buy-backs [14] which could be used as an incentive for corporate activity that is either boundlessly expansionary or simply accounting fraud. Such elasticity features enable companies to reduce their default risk and stay out of serious financial distress resulting from a short-term failure of VAMs. Thus, this model not only helps in maintaining the liquidity of corporate capital but also helps in meeting the demands of investors towards risk mitigation in accordance with the goals of risk management of Valuation Adjustment Mechanisms.

5.2. Regulatory alignment

The regulatory authorities should also define the limits of validity of VAMs clauses in the Company Law, providing the capital market with a uniform framework for compliance with the contracts, and with predictable legal consequences. Moreover, the legislative level, it is necessary to clarify the range of application of mandatory provisions, such as differentiating between the validity-implementing mandatory rules and administrative mandatory rules, thus reducing the different standards in judges' practice related to the regulation's scope of application. Finally, since the principle of capital maintenance is the major institutional constraint for enforcing buy-back obligations, this paper suggests considering a third-party solvency test as an alternative benchmark. This framework can effectively balance the protection of portfolio companies' creditors and buy-back mitigation needs of investors through the establishment of the dynamic solvency evaluation model [15].

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6. Conclusion

The Valuation Adjustment Mechanism (VAMs) is without doubt an important risk management mechanism in private equity investments. Uncertainties about the legal enforceability and the complicated nature of the existing dispute resolution mechanisms, however, often limit its ability to contribute to the mitigation of the risk.

In order to make VAMs true and effective risk-hedging instruments, the legal bindingness of such instruments must be explained and the basic corporate law concepts, such as the capital maintenance rule, must be strictly complied with. In addition, risks need to be shared in an equitable way, using flexible compensation schemes. In the end, a quick, effective and sturdy dispute resolution tool is essential as the last resort. It not only helps achieve the goals of risk management, but also ties up the various interests of investors and founders to a certain extent.

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