

A Study on the Legal Validity of Adjustment Valuation Mechanism

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Abstract—Adjustment Valuation Mechanism is an investment agreement between the investors and financiers, in dealing with the unknown development situation, which is to guarantee the investor's legitimate interests. Most Adjustment Valuation Mechanisms are signed with offshore companies as the main body for confidentiality. But in recent years, because of the court's public decision on these kinds of cases, the Adjustment Valuation Mechanism has surfaced, which arises the attention of the researchers and the law workers. The essay talks about the production and development of Adjustment Valuation Mechanism in the environment of the rapid economic development. The essay is aim at finding the confirmation of the validity of Adjustment Valuation Mechanism.

Keywords—Adjustment Valuation Mechanism; legal effect; investment; validity; venture capital

I. INTRODUCTION

With the rapid development of economy, venture capital industry increased rapidly. The Adjustment Valuation Mechanism is more mature in the developed capitalist markets in Europe and the United States, while in China such mechanism is immaturity. In the light of Chinese national conditions and the current market environment, it is needed to consider it further. The paper based on the classic cases of MengNiu dairy industry, the Prince's milk industry, Xugong Company and Suzhou Haifu Company analyzed the cases in order to explore the legal validity of the Adjustment Valuation Mechanism.

II. AN ANALYSIS OF THE LEGAL VALIDITY OF THE CASES RELATED TO ADJUSTMENT VALUATION MECHANISM

In china the first stage of the Adjustment Valuation Mechanism signed in 2003, three investment institutions represented by Morgan Stanley who signed the contract with management of Mengniu Dairy Co., Ltd. Mengniu Dairy accepted Morgan Stanley's capital injection and then through offshore companies injected into the Mengniu dairy industry, effectively circumvent the regulation of the law. Morgan Stanley with the other two investment institutions becomes indirect shareholders, holding convertible securities of the company. The investors give up the administrative authority, limited to investment only. In a short time, Mengniu huge sums of money injected to the company but the company also carries the commercial risk.

Suzhou Haifu Company and Hong Kong Dia Co., Ltd., Gansu Shiheng Nonferrous Resources Recycling Co., Ltd. Capital increase dispute case has the name of "the first case of Adjustment Valuation Mechanism". Haifu Company conduct prosecution with Lanzhou Intermediate people's Court in Gansu Province because Shiheng Company failed to achieve the agreed results, asking Shiheng Company, Dia Company to compensate it and bear the related costs. Haifu Company appealed against the first instance judgement and then filed second instance judgement in the court, at last filed a retrial application with the Supreme people's Court for a retrial judgment. Prior to this, Adjustment Valuation Mechanism is very private; the contract signing is generally unknown to outsider. For "the first case of Adjustment Valuation Mechanism", the public judgment of the dispute by the court, Adjustment Valuation Mechanism was brought to the surface. It has attracted more and more attention of the research from legal workers and scholars.

The financing party of prince's dairy industry in order to let the company listing smoothly, they received the investments from Morgan Stanley and other three investment institutions co-operated to set up offshore companies. However due to the outbreak of melamine, the Chinese dairy market fell into the lowest point, the capital of the prince's dairy industry went bankrupt, and MR Li and his wife were forced to transfer their shares for failing to reach the agreed results, which led to the double lose situation.

Xugong Company, as a wholly state-owned government enterprise, takes the pricing of state-owned assets as a gamble in foreign capital acquisition cases essentially is an option, also an incentive to investors Carlyle company. But because of its state-owned nature and its industry is also related to the development of the national equipment manufacturing industry, the Development and Reform Commission shall not approve the holding of foreign capital. The company's development may change the structure of the national economy; Carlyle Company has no chance but to cut down the shares. So the stockholder is still its parent company.

The agreement that Haifu Company require Gansu Shiheng Company and Hong Kong Dia Company to compensate them under the condition that their performance is not up to standard. It is in violation of the provisions of Article 4 of the Supreme People's Court on the answers to certain questions concerning the hearing of disputes

concerning Joint Venture contracts, and similar to a loan with a guaranteed clause of the contract — when the performance terms of the financier are not up to standard, it should be compensated with cash or equity, or even if the proportion of compensation is higher than that of its party. In fact "it is a joint venture, and it is a loan". The Adjustment Valuation Mechanism between the companies is considered to be a joint venture, a loan, is the ineffective contract.

It is thought that the main basis for holding the effective view of the Adjustment Valuation Mechanism is that the Adjustment Valuation Mechanism conforms to the requirements of civil legal act, that the Adjustment Valuation Mechanism does not violate the principle of equivalent compensation and fairness and that the rationality of Adjustment Valuation Mechanism should be confirmed by law.

While there's another voice appealed, they hold main reasons for the invalid view are that the Adjustment Valuation Mechanism called "consortia, in fact, borrowing", which violated the principle of fairness and the prohibition of abuse of shareholders' rights, blurs the boundary between equity and creditor's rights, and the huge amount of cash compensation impacts on the principle of capital maintenance.

III. THE PERFECTION OF THE LAW OF "ADJUSTMENT VALUATION MECHANISM"

Discussing from different angles such as civil law, commercial law and so on, Adjustment Valuation Mechanism is an instrument of financial derivatives. It is the institutional investor's share incentive mechanism to the management of the target company. There is a huge difference between the two in terms of legal relation, but both of them have the same nature in the aspect of equity incentive. Those cases didn't reveal the essence of law. They both agree that the design of Adjustment Valuation Mechanism has lever mode. The high profits accompany with the high risks. Essentially Adjustment Valuation Mechanism is a double-edged sword, high return accompanied with high risk. It should be treated properly.

A. *To Improve the Legal System So That It Can Be Governed by the Law*

The government should improve relevant laws and regulations and give full play to the regulatory role of economic law on the market economy and promote the legality of Adjustment Valuation Mechanism in administrative regulations. Then the Adjustment Valuation Mechanism can protect the rights and interests of the investors, which can promote the development of equity investment and financing market. Only in this way can it be possible to solve the minor enterprises financing difficulties.

B. *To Perfect the Supervisory System So That It Is Governed by the Law*

Regulators play their role as leaders and facilitators of market economy to guide the behavior of the main body of

the market in a reasonable and legal manner so that they can achieve the realization of private equity investment for the development of small and medium-sized enterprises. It is our responsibility to monitor enterprises in various fields, especially the IPO area. Also the government is bound to strengthen the examination of the listed enterprises in the Adjustment Valuation Mechanism. People shouldn't only pay attention to the development of large enterprises, but also the encouragement of those small and medium-sized enterprises' development. Our government should provide more service and policy to support the development of small and medium-sized enterprises.

C. *To Construct the Multi-level and Regional Financing Market*

The government should encourage the development of the market economy at the same time of macro-control. Encouraging the development of market economy and promoting the financing market. The government should establish a sustainable development and orderly market system so that the companies can have a health environment. Creating Multi-level and Regional financing Market to provide a wider and broader platform and channel for the enterprise development.

D. *To Normalize the Procedure of Judicial Dispute Procedures*

People should respect the principle of self-government and the government needs to provide a fair trade market environment for enterprises. When come across the dispute, the judicial organs need to judge whether the parties follow the principle of good faith or not. The society needs to respect the principle of matching the risk and the income and the principle of the diversification of the shareholder's rights. It is needed to strength the revision of the contract, follow the principle of finding that the contract is in force with the efficiency of economic law, and make measures to keep the rights and obligations of the relevant subjects in a stable state. Promote the regularization of the flow of financing funds.

IV. CONCLUSION

Adjustment Valuation Mechanism is a kind of financial innovation tool with Chinese characteristics. Some inconsistencies between the various provisions contained in the Adjustment Valuation Mechanism and existed in laws and regulations in China and also the risks associated with the association of gamblers, which aroused people huge controversial about the legal effect of the Adjustment Valuation Mechanism. The essence of the "Adjustment Valuation Mechanism" is that the information between the investment institution and the financier is asymmetric. There are differences in price valuation so that exist distribution of capital market benefits. The bet of the deal is a double-edged sword, on the one hand, it can protect investors' rights and interests and play the role of attracting funds, and while on the other hand, the property of the financing subject company or the interests of the shareholders or creditors of the financing subject company can also be infringed. While facing the market failure, it is needed to follow the guidance

of the adjustment function of Economic law. The government should give full play to the moderate intervention and social standard principle of Economic Jurisprudence. It is necessary to hold the concept of justice to make good a defect of legislative gaps. The solution of legal validity of Adjustment Valuation Mechanism can protect the rights and interests of equity investors and reduce the risks of investment. Promoting the Development of Equity Investment and financing Market and providing a healthy environment for the investors. Chinese government needs to promote the rapid development of the national economy by adjusting capital flows.

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