Analysis of common dispute focuses and relevant legal issues in VAM disputes

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In the past two years, the authors have represented a series of investment dispute cases, arising from PE investment enterprises' investment in domestic enterprises and involving the currently popular VAM. For the purpose of communication and discussion with peers, we hereby conduct collection and research on common dispute focuses and relevant issues in these cases.

1. Brief introduction of VAM

1. 1 Concept of VAM

VAM refers to valuation adjustment mechanism, in which the investor's enterprise valuation is adjusted according to the invested enterprise's actual business performance.

In general, the common pattern of VAM is that the investor buys a share of the enterprise at a high premium, and the invested enterprise and its actual controller make corresponding commitment with respect to the future performance. If the agreed performance index is achieved later, the invested enterprise and its Old Shareholders (hereafter referred to as "Old Shareholders") are entitled to exercise certain rights(for example, to purchase the stock equity of the invested enterprise held by the investor with a relatively low price). The investor, conversely, is entitled to exercise certain previously agreed rights (for instance, to require the invested enterprise or its Old Shareholders to pay the compensation in cash or repurchase the stock equity, etc.).This kind of agreement is vividly called "Bet On Protocols" in China as it is possible for both parties to earn profit or suffer loss due to uncertainty of the invested enterprise's future performance.

VAM usually contains several major clauses, such as performance compensation clause, buy-back clause, non-competition clause, clause of investor's other rights and obligations etc. Sometimes it also includes anti-dilution clause, invested party's warranty clause, preemptive right clause, and maintenance of actual controller and the operating management stable clause and other clauses which will not be repeated hereby.

1. 2 VAM's legal force under Chinese Law

The most famous VAM dispute case is obviously the Hifur investment case reviewed by the Supreme Court, court decision of which was once summarized by the industry insiders as "to bet with shareholder is effective, but ineffective with company". CIETAC, however, changed this situation with an arbitral decision in 2004. In that case,

CIETAC confirmed not only the effectiveness of VAM between the investors and major shareholders but also the force of performance compensation clause between the investor and the enterprise.

There are still many uncertain factors in deciding VAM's legal force due to the abovementioned examples and the fact that Chinese judicial precedents and arbitral decisions are not necessarily followed in other cases. The authors will go into further discussion hereinafter with relevant issues confronted in practice.

2. Analysis of common dispute focuses in VAM dispute cases

VAM investment dispute cases represented by the authors involve all kinds of legal issues and defense focuses. Since details of cases are different, and some issues are not clarified in Hifur investment case, we will discuss respectively as follows:

2.1 Effectiveness of VAM(clauses) without approval in the foreign investment

Different from domestic enterprise, foreign-owned enterprise's contract, concluded in the process of enterprise formation and modification, will become effective only after being approved by the competent foreign investment department. The major legal ground is article 14 of *Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment*, which stipulates that "The agreement, contract and articles of association shall come into force after being approved by the examination and approval authority. The same applies in the event of amendments". Furthermore, *Provisions of the Supreme People's Court on Several Issues concerning the Trial of Disputes Involving Foreign-Owned Enterprises (I)*(hereinafter referred to as *Judicial Interpretation of Disputes Involving Foreign-Owned Enterprises*), published by the Supreme Court in 2010, also regulates that "Where a contract concluded during the formation, modification, etc. of a foreign-owned enterprise does not take effect until it is approved by the foreign-owned enterprise examination and approval organ in accordance with the laws and administrative regulations, it shall become effective upon the date of approval. If the contract is not approved, the people's court shall determine the contract as ineffective."

In an investment dispute case represented by the authors, the invested party was a JV enterprise, and the VAM signed by it was not approved by the competent foreign investment department, while the agreement approved did not include VAM clause, i.e. the "twin contracts" commonly known in the industry.

The question therefore resulted is whether this kind of unapproved VAM in foreign investment is effective or not?

The Hifur case gives no answer to this question. In the fact-finding part of the first instance judgment of Hifur case, there is a statement which says "*Reply on capital*

increase and shareholding transfer of Gansu Zhongxing Zinc Industry Co.,Ltd. approves capital increase and shareholding transfer, and also approves that capital increase agreement and JV enterprise's contract and constitution take effect immediately. " The abovementioned capital increase agreement includes performance compensation clause and buy-back clause. In consequence, the capital increase agreement in Hifur case is effective as it has completed the examination and approval procedure for the foreign investment, but controversy over specific clauses arises among the parties and courts at different levels. Consequently, where the Supreme Court makes no explicit requirement for the examination and approval of foreign investment agreement, we believe that there exists great uncertainty in trial practice whether court will judge the VAM ineffective merely because it is not approved by the competent foreign investment department.

In this respect, there are two general opinions in practice as follows.

One opinion is that clauses stipulated in VAM should be respected because they are results of autonomy of will. Moreover, compared to equity transfer agreement which should be submitted to approval, VAM is a kind of supplemental agreement concluded for relevant issues of foreign-owned enterprises. According to the article 2(1) of *Judicial Interpretation of Disputes Involving Foreign-Funded Enterprises*, where supplemental agreement does not constitute material or substantive change to the contract that has already been approved, the people's court shall not determine that the said supplementary agreement has not come into effect on the ground that it has not been approved by the examination and approval authority for foreign-owned enterprises. Meanwhile, paragraph 2 of this article further regulates that "material or substantive change" shall include changes in the registered capital, type of company, business scope, term of business operation, amount of capital contribution subscribed for by the shareholders, or way of capital contribution, and merger of companies, division of company, equity transfer, etc. As VAM is not listed, it shall be deemed to take effect without approval of the competent foreign investment department. In addition, if VAM, from the perspective of social demonstration effect of a judicial decision, is deemed invalid because it is not approved, the influence will be too great as the whole investment rule and moral baseline might be remodeled. Such clauses, in consequence, shall not be deemed void even without any approval.

The other opinion is that we should obey unmodified laws and judicial interpretations, which regulate that foreign-owned enterprise's JV contract and agreement should take effect after approval. According to abovementioned laws and judicial interpretations, however, effectiveness of such clause majorly depends on whether this kind of clause or agreement belongs to "contract concluded during the establishment or modification of foreign-owned enterprise" or "supplemental agreement". In case of "supplemental agreement", the point is whether it constitutes "material change" to the approved contract. If the answer is affirmative, it can take effect only after approval.

We hold the view that there are two reasons why it is so common to sign "twin contracts" for VAM in the field of private equity investment. For the first reason, usually the ultimate goal of invested enterprise is to go public. According to *Administrative Measures for Initial Public Offering and Listing of Shares*, however, enterprise which intends to be listed should have stable equity structure and clear shareholding. CSRC is extremely reluctant to accept material equity change or shareholder dispute brought by VAM after going public. Enterprises, as a result will often sign a supplemental agreement to cancel VAM. To avoid troubles and risks brought by it, some enterprises choose not to put VAM clause in approved contract at the beginning of investment. For the second reason, the competent foreign investment department might refuse to approve due to the fact that VAM itself may lead to uncertain legal result. In other words, VAM may not even be approved. Investor and invested party, accordingly, choose to sign twin contracts to avoid this, i.e. declaration of will for VAM is true, while parties decide not to disclose to the public. In consequence, the first opinion is somewhat reasonable from the perspective of respecting parties' true declaration of will.

However, we also believe that the currently effective law shall not and cannot be ignored. It, even if out of time, should be observed before amendment or abolishment. The second opinion, therefore, is supported by statutory law and can help to build a balance between obeying law and respecting autonomy of will.

Then how to confirm validity of unapproved VAM? In our opinion, there should be two distinctive conditions.

Unapproved foreign-owned agreement usually includes two forms: one is two versions of contract title (such as capital increase agreement) with extremely similar content, and signed almost at the same time. The difference is that parties add some clauses, specific in VAM, in unapproved version, such as performance compensation clause, buy-back clause, i.e. twin contracts commonly known in the industry. The other one is supplemental agreement which will not be submitted to examination and approval. It is signed after the conclusion of the agreement which needs to be approved. Relevant content of VAM is stipulated in the supplemental agreement.

In the first situation, confirmation of the agreement of non-approval version, from the point of maintaining uniformity of legal interpretation, should be the same with that of approval version, as their contents are almost the same. The difference is merely that the parties add some clauses related to VAM in "twin contracts". Taking JV's VAM dispute for example, if the agreement of approval version, according to the abovementioned analysis, is deemed as JV contract or agreement by the competent foreign investment department, the non-approval version shall not be deemed as supplemental agreement but obtain the same evaluation. This kind of agreement, according to *Judicial Interpretation of Disputes Involving Foreign-Owned Enterprises*, shall not take effect without approval.

In the second situation, the core question to effectiveness of VAM (namely supplemental agreement) is whether such clause constitutes "material change" to the approved agreement. In other words, whether the fact that not being listed in article 3 of *Judicial Interpretation of Disputes Involving Foreign-Owned Enterprises* does not belong to material change is true or not?

We consider that the answer is negative. No matter how wise the legislators are, they cannot totally foresee the complicated commercial relationships or commercial modes generated from social and economic development, not to say list them one by one (VAM clause is such a new thing generated from economic development, and it is impossible for legislators to foresee and prescribe in advance). Because of this, article 2(2) of *Judicial Interpretation of Disputes Involving Foreign-Owned Enterprises* (further explanation of "material or substantive change") does not take exhaustive list measure. Consequently, even though this article does not clarify that VAM constitutes "material or substantive change" to the approved contract, we still cannot reach the conclusion that VAM does not belong to "material or substantive change". Furthermore, the reason why legislators do not choose exhaustive list measure is to leave interpretation space for judicial offices during trial process.

In that way, the next question is what kind of standard that court will use to judge whether VAM agreement (clause) constitutes "material or substantial change" to the approved agreement.

In this regard, one opinion is to make judgment by referring to regulations of normative documents issued by the competent foreign investment department for approval. For instance, article 1 of *Notice of the Ministry of Commerce on Further Simplifying and Regulating Administrative Licenses for Foreign-Invested Owned Enterprises*, published by Ministry of Commerce in 2008, lists several types which do not constitute substantive change, namely "the change in the name of a foreign-owned enterprise, change in the name of an investor, change of the business premises within the same city, change in the composition of the board of directors, and change in the term of duration in compliance with the law". Some local competent departments of commerce also published relevant documents, defining non-substantial change. For another example, article 2 of *Notice of Department of Commerce of Zhejiang Province on Further Simplifying Examination and Approval Procedures with respect to issues like such as non-substantial change for Foreign-Owned enterprises* prescribes that "non-substantial change issues refer to change of non-substantial contents of contract and AOA of foreign-owned enterprises, including the change in the name of a foreign-owned enterprise, change of investor's information (including name(not equity transfer), legal representative and legal address), change of legal representative, change of the business premises (not for production) within the same city, change in the composition of the board of directors, and change in the term of duration in compliance with the law". As a result, issues listed before do not constitute "material or substantial change" in principle, and issues not listed absolutely do.

As far as we can see, opinions mentioned above are too simple. There is no doubt that relevant standards of administrative department can be a reference, but they are not the sole judgment standard. In the end, in order to judge whether a VAM clause constitutes material or substantial change to the approved agreement, we should review whether body content of relevant agreement involves adjustment of substantive rights and obligations of shareholders and foreign-owned enterprises.

We, accordingly, hold the view that since VAM (performance compensation) clause and buy-back clause usually stipulate that enterprise and old shareholders shall pay investor a large number of money when performance goal is not achieved, and shall also buy back or accept equity when investor quits, a series of great changes, such as invested enterprise and Old Shareholders' registered capital, equity transfer, and debt paying ability, etc. will be involved. Relevant clauses, being obviously unjust, are more likely to directly influence existence of invested enterprise and Old Shareholders. Most of VAM agreements (clauses), in consequence, shall be deemed to constitute "material or substantive change" to the approved agreement, and can become effective only after approval.

We have consulted several senior judges with respect to the abovementioned issue whether VAM is effective without approval. Judges, in general, are reluctant to treat VAM void just because it is not approved. It seems to be a trend in trail to respect parties' true declaration of will and spirit of contract.

This kind of trail trend do not certainly mean that court will ignore laws and regulations involving foreign-owned enterprise, which stipulate that foreign-owned enterprise's contract shall become effective after approval. The difference of this kind of regulation and value orientation actually brings about difficulty in trial practice. A judge, during a conversation, has provided another way of thinking, i.e. only review whether VAM clause directly leads to occurrence of issues which need competent department's approval, such as equity transfer, capital increase, and so forth. If there is no such kind of condition, the agreement can be deemed effective even without the approval of the competent foreign investment department. According to this way of thinking, performance compensation clause and buy-back clause, common in VAM, can take effective without approval.

Ministry of Commerce, just before we draft this paper, published *Foreign Investment Law of the People's Republic of China (Draft for Comments)*, which cancels the system which requires the examination and approval for foreign investment one by one, and adopts information report system. Investor can make report within 30 days after occurrence of issues such as equity transfer and capital increase, and approval of the competent foreign investment department is not a precondition. Accordingly, we might forecast that the issue whether VAM is effective without approval will not be a dispute focus in this kind of cases in the immediate future. Before *Foreign Investment Law of the People's Republic of China* officially takes effect, and before there is a

conclusion regarding the retrospective effect of the law, we believe that it is still worthy of discussion with respect to this issue.

2.2 Analysis of effectiveness of VAM clause

Under the circumstance in which VAM is approved by the competent foreign investment department, the case focus usually relies on discussion over clauses. Except for defenses denied in judicial practice, such as the claim that VAM "should be deemed void as it is debt in the name of investment", there are several following defenses worthy of discussion.

2.2.1 With respect to VAM with enterprise

In respect of effectiveness of performance compensation clause between investor and invested enterprise, the Supreme Court indicates in the Hifur investment case that the stipulation about performance compensation guarantees investor's relatively stable income in invested enterprise, which is separated from Shiheng company's business performance and will impair interests of invested enterprise and its creditors. To require invested enterprise to pay compensation amount to investor, in consequence, violates article 8 of *the PRC Law on Chinese-Foreign Equity Joint Ventures*, which regulates that parties shall distribute profit based on the proportional ratio of the registered capital for each party, and article 20 of *Company Law*, which prescribes that shareholders shall not prejudice the interests of the creditors of the company by abusing the independent legal person status of the company or by abusing the limited liabilities of the shareholder.

In all kinds of VAM cases hereafter, the defense party always uses this as a powerful defense. For a moment "VAM with enterprise is void" seems to be an unquestionable solid rule.

A similar case in CIETAC in 2014, however, broke through the above "solid rule" made in Hifur case, and confirmed the effectiveness of performance compensation clause between the investor and the invested enterprise.

To our point of view, the arbitration is reasonable to certain degree. Investor, before becoming shareholder of the enterprise, signs a contract according to *Contract Law* rather than company-related laws. Moreover, capital invested by investor is often several times higher than the present equity value of the enterprise. Consequently, it is an obvious damage to autonomy of will and spirit of contract to use regulations in company-related laws to deny effectiveness of clauses in agreement during the process of contract performance. From a certain perspective, when investor asks for performance compensation according to investment agreement with enterprise, its identity is the same as other creditors, so it is a violation of principle of fairness and reasonableness to deprive its claim for compensation.

From another point of view, we believe that when talking about effectiveness of "VAM with enterprise", we should consider not only jurisprudence but also actual condition of the field of equity investment in China. We notice that investors, in practice, often have better investment experience and risk prevention and control conscience, so there are many one-way performance compensations with enterprises, i.e. there is only penalty clause when performance does not reach the goal and there is no award clause when performance reaches the goal. The adopted computational formula, moreover, will give great economic burden to invested party. Under this circumstance, if we blindly confirm effectiveness of this kind of clause, the enterprise may bear great financial risk, which will cause a chain of problems such as protection of other creditors and existence of industrial entity. In consequence, we think that effectiveness of "VAM with enterprise" can be confirmed if parties stipulate two-way VAM clause and relevant compensation computational formula is basically reasonable. On the contrary, if the agreed performance compensation is one-way, and computational formula excessively tends to protect investor's interest, court should, from the perspective of protecting public interests, properly adjust rights and obligations of the parties. The Supreme Court, in fact, made retrial decision after comprehensively considering the legal system, value orientation, and development status of investment field in our country. Courts, as a result, should not simply follow the retrial judicial decision of Hifur case, and should make distinction according to actual situation of the case.

2.2.2 With respect to violation of *the PRC Law on Chinese-Foreign Equity Joint Ventures* due to VAM between shareholders

According to article 4(3) of the *PRC Law on Chinese-Foreign Equity Joint Ventures*, "the parties to an EJV share profits, risks, and losses in proportion to their registered capital". As a result, when invested party is an EJV, Old Shareholder always defense that according to abovementioned law, parties to an EJV shall mutually bear risks and share profits, and cannot stipulate to share profits and bear risks in a proportion different from registered capital proportion or in other ways.VAM clause (performance compensation clause) in investment agreement, however, stipulates that investor can obtain compensation when enterprise's performance does not reach the goal. The essence is to free investor, as a shareholder, from investment risks and to guarantee its certain profits under whatever circumstances. This kind of clause is void as it obviously violates the abovementioned regulation which requires the parties to an EJV to mutually bear risks.

In our view, although T*he PRC Law on Chinese-Foreign Equity Joint Ventures* has the abovementioned regulation, such regulation merely normalizes the basic profit distribution mode, and does not exclude other profit distribution modes stipulated by parties to an EJV on this basis. Furthermore, profit after distribution belongs to the investor, whose disposal has nothing to do with EJV. Therefore, it is investor's disposal of its own rights when such clause is deemed to be investor's another disposal of its profit after distribution of profits among investors. The conclusion of invalidity cannot

be reached therefore, and this kind of defense is hard to be supported by court.

2.2.3 With respect to the obvious unfairness

According to article 72 of *Opinions Concerning General Principles of the Civil Law*, where one party takes advantage of his/her strengths or of the other party's lack of experience, making the rights and obligations between both parties obviously contrary to the principles of fairness and transaction based on compensation and price-value consistency, obvious unfairness may be deemed. *General Principles of the Civil Law* and *Contract Law*, under the circumstance of obvious unfairness, endow the damaged party the right to ask court or arbitration organization to revoke or modify contract.

In VAM dispute, common defenses with respect to obvious unfairness are aimed at issues such as "no deduction in buy-back" and "one-way VAM". The so called "one-way VAM" refers to VAM clause which only stipulates compensation when performance does not reach the goal but not prescribes award when performance reaches the goal. For investor, there is only profit without risk, but for invested enterprise there is only penalty without award, so it is not "VAM" any more. The so called "no deduction in buy-back" means that when investor requires Old Shareholders to buy back its equity, the buy-back amount shall not deduct cash compensation paid before. In VAM dispute, especially when agreement adopts both two abovementioned clauses, invested enterprise usually claims that these clauses constitute "obvious unfairness", and asks the court, according to law, to revoke them or at least adjust, according to the principle of fairness, the compensation amount generated thereof.

In respect of this kind of defense, investor usually explains legitimacy of one-way VAM (performance compensation) clause from the following points. Firstly, VAM is an investment agreement concluded after equal consultation among commercial bodies, and professionals always participate in the signing process, so the situation in which invested party is not experienced or the status of parties are not equal does not exist. Secondly, investor obtains corresponding equity at a high premium, which means that capital invested is not equal to current value of equity, so investor also bears huge capital pressure and investment risk. Performance compensation clause, in consequence, actually is used to guarantee that investor can ask for return of overpaid investment amount when future enterprise value does not reach investor's expectation or invested party's promised situation. Considerations of two parties paid for investment are basically equal. At last, there always exists profit and loss in commercial game, and parties should fully foresee this and be responsible for their commercial activities. Judicial organizations should focus on maintaining justice in procedure in commercial activities rather than guarantee an absolute justice in result. Revocation or modification of this kind of clause not only damages spirit of contract, but also violates justice in procedure.

To this point, we hold the view that on the one hand, although signing parties of VAM are commercial bodies, they do not necessarily have the same negotiation ability and transaction experience, and the situation in which powerful party uses these advantages to excessive profit cannot be excluded. In cases to which we get access, invested enterprise is usually on the weak position during contract conclusion, while investor, as the experienced player in a true sense, has established a whole set of protection system for the investor's profit. In addition, due to the overall background of high financing cost of enterprise, entrepreneur usually lacks investor's reason when making commercial choice. Under this premise, if we still enlarge legitimacy of autonomy of will without limit, we might stimulate investor's speculative psychology for quick success, and even cause moral hazard and damage industrial entity and public interest. On the other hand, however, it is not proper to revoke or modify VAM clause just because it is one-way and certainly constitutes obvious unfairness. Such clause can be adjusted only when it is not only one-way but also a violation of fairness and justice in essence.

In a case represented by the authors, VAM signed by parties adopts the articles of "one-way VAM" and "no deduction in buy-back". Investor, accordingly, is entitled to enjoy three following results when performance goal of the invested enterprise is not reached even the later obtains considerable profit: a. investor basically takes back its whole investment amount within two years through cash compensation while keeps its equity; b. investor obtains certain amount of dividend every year; c. investor can require Old Shareholder to buy back its equity by paying entire initial investment amount and relevant interest.

In our opinion, under adjustment of standard VAM clause, capital invested by the investor will finally be equal or close to actual value of equity. The consequence caused by performance compensation clause in this case is that investor basically takes back its entire investment amount in two years and can keeps its equity under the condition that invested enterprise makes profit but still does not reach performance goal. This means that investor uses zero cost to obtain invested enterprise's valuable equity (the equity generates relatively stable dividend and can be changed into large sums of money, not lower than investment cost, when quit in the future), so it is quite unfair for invested enterprise.

Viewing from short-term investment interests, it is not hard to find out that investor can even profit more from the fact that invested enterprise' performance does not reach the goal. The VAM (performance compensation) clause obviously contains moral hazard. In this case, investor actually is suspected of impairing invested enterprise's interests, which to certain degree causes the failure of the invested enterprise to reach the goal and then leads to application of compensation clause. It is very hard to say that this is just a coincidence.

In conclusion, we believe that in case that there exists material defect of

compensation clause, the actual effect does not meet invested enterprise's original intention, the court should adjust this kind of clause which obviously violates fairness and justice.

Needless to say, it is extremely difficult for judges to adopt, in practice, defense of obvious unfairness. The result of directly revoking obviously unfair clause will be too serious, while modifying or adjusting content of clause will cause the tough problem of "how to change". Consequently, the final result usually is to implement according to parties' agreement since the penalty of revoking is too strict while modifying clause lacks reference and basis.

We should, however, pay attention to two details in Hifur investment case. Firstly, according to the computational formula of the fact-finding part of the case, buy-back amount of bay-back equity in the future can deduct cash compensation paid by Old Shareholders. In other words, invested party, viewed from actual effect, just returns bubble equity consideration in advance, and compensates for interest loss of occupied investment amount. Secondly, the Supreme Court leaves a "significant" sentence at the end of judicial decision of Hifur investment case, i.e. "Our court confirms that Diya company has not raised any objection to compensation amount and computational method brought by Hifur." It is reasonable for us to speculate, accordingly, that if invested party objects to computational method or relevant clauses do violate the principle of fairness and reasonableness, court can adjust by using its discretion. In other words, we have reasons to believe that the Supreme Court has left certain freedom for courts at different levels to deal with this issue.

2.3 **Other defenses**

2.3.1 With respect to investor's breach of contract

The defenses mentioned above are against VAM clauses. When VAM clauses are not questionable, focus of argument will be transferred to whether investor breaks the contract or not, i.e. whether investor is responsible for or has made mistakes in preventing invested enterprise from reaching the performance goal.

In another case in which investor sues enterprise for paying performance compensation amount, the two parties agree that investor enters into the enterprise in the name of strategic investor, who has the right to appoint a director as a member of board of directors of the enterprise, and specifically provide the investor's assistance obligation and non-competition obligation (namely forbidden to invest enterprises which compete with the invested enterprise). Investor, however, never participates in operation and management of the enterprise after payment of investment amount. In addition, Old Shareholder also finds out that investor's affiliate enterprises and general partners, during performance of the agreement, invest direct competitors of the enterprise through a series of M&A.

At this point, we hold the view that invested enterprise can claim, according to the rule of the defense of first-performance in the *Company Law*, that investor breaks the contract before and is in obvious fault with respect to the result that enterprise's performance does not reach the goal, so it is not obliged to pay for compensation amount. It is necessary to state that there are a large number of investment contracts stipulating that investor enters into the enterprise as strategic investor. Strategic investor, by reference to definition in relevant documents of CSRC, is a legal person which has close business contact with issuing company and will hold the latter's shares for a long period of time. According to common sense, strategic investor usually refers to large enterprise or group at home and abroad, which enjoys the advantages of capital, technology, management, market, and talents. Focusing on long-term investment cooperation and pursuing for long-term interest return and sustainable development, it can promote upgrading of industrial structure, strengthen core competition and innovation capability, and expand market share of product. Different from simple financial investor, it has more obligations, which are major obligations stipulated in the contract, to help and promote invested party from all sides. Investor's failure to perform such obligations, therefore, may constitute material breach of contract. Besides, although it seems that investor does not invest direct competitors of invested enterprise, it still constitutes a breach of contract, which is a hidden breach and reveals its subjective malevolence more obviously, because investor and its general partners, affiliate enterprises are actually controlled by the same decision-making level, and there exists mixture of personnel and mixture of business. Court, as a result, should confirm investor's unfair dominating and controlling action, which essentially violates non-competition clause. This case, in the end, is closed by reconciliation which favors invested enterprise.

2.3.2 With respect to the fact that performance compensation is in essence liquidated damages

As discussed above, there are many one-way VAM clauses in practice, stipulating that invested enterprise cannot deduct buy-back amount in buy-back. We, therefore, have brought a new thought in the trial, i.e. this kind of clause essentially deems enterprise's failure to complete promised performance as a breach of contract, and gives investor the right to ask for compensation when this kind of situation occurs. Performance compensation amount, accordingly, is liquidated damages in nature. Invested party, also on this basis, can ask court or arbitration organization to make adjustment in accordance with the rule concerning excessive liquidated damages in *Contract Law* and its judicial interpretations.

This kind of defense has two major advantages. Firstly, it solves, to certain degree, the problem that court lacks reference of modification when facing defense of obvious unfairness. According to article 29 of *Interpretation II of the Supreme People's Court of Several Issues concerning the Application of the Contract Law of the People's Republic of China*, "Usually the liquidated damages stipulated by the parties exceeds

30% of loss, it can be deemed as too much higher than the loss caused". Court can make corresponding adjustment according to this standard. Secondly, distribution of burden of proof with respect to damage amount in judicial practice has not been totally unified. Consequently, when enterprise fails to reach performance goal but still has pretty good business condition, investor can still get certain amount of investment return. If court distributes burden of proof to the investor, and it cannot fully prove the fact, the possibility that its appealed amount will not be supported or fully supported will greatly increase.

The above are some experience and thoughts of the authors obtained by representing VAM dispute cases. Most of questions mentioned above are not discussed or solved by the Supreme Court in the Hifur case, to which the investors and enterprises may need to pay attention for the purpose of better reduction of legal risks and protection of their own legitimate rights.