

Analysis on the Legal Effect of Liquidation Priority Clause in Private Equity Investment

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Abstract: The liquidation priority clause mainly comes from the exit link of the invested enterprise when the liquidation event occurs, and it is an important legal basis to guarantee the rights to obtain limited economic returns according to the contract content. However, due to the imperfect legal content in China, there are still some doubts about the legal effect of the liquidation priority clause, which affects the perfection and rationality of the withdrawal mechanism of private equity funds. Based on this, this paper expounds in detail the legal effect of the liquidation priority clause in the event of special events in private equity investment activities, hoping to draw lessons from it.

Keywords: Private equity investment; Liquidation priority; Legal effect

1. Introduction

With the support of policies, the investable capital of China's private equity investment market has increased sharply. According to the statistics of the open market, the annual investment transaction volume of China's private equity market hit a 10-year high in 2021, reaching \$128 billion. In 2022, the amount of newly raised funds was \$247.6 billion. It can be seen that the financing quantity and development scale of private equity investment activities in China are growing rapidly. However, there are some hidden risks in the rapidly developing market environment. Therefore, strengthening the research and analysis on the legal effect of liquidation priority clauses has become an important issue in building exit channels for private equity investment and promoting the development of private equity investment^[1].

2. Concept and Classification of Liquidation Priority

Liquidation priority in the context of French-speaking environment in China essentially refers to the right that the parties clearly stipulate in the private equity investment contract after friendly negotiation that once the invested enterprise is liquidated in an accident, the right subject can get the corresponding remuneration from the remaining property of the enterprise in the first order^[2]. Liquidation priority is mainly divided into the following types:

2.1 Non-participating liquidation priority

That is, investors get the return of investment amount and interest according to the contract content. When the founder belongs to the dominant party, he can get the amount of compensation in the first order, but he has no right to participate in the redistribution of the remaining property.

2.2 Priority of participatory liquidation

That is to say, when the liquidation priority subjects get corresponding returns, if the enterprise still has surplus property, it can participate in the distribution of surplus property and obtain corresponding property according to the proportion of shares held, and there is no upper limit. This kind of distribution means that the world is at a disadvantage and cannot inspire the founders.

2.3 Liquidation priority with upper limit

It means the amount of return obtained by the liquidation priority subject participating in the redistribution of enterprise surplus property is stipulated. This distribution method is the integration of

non-participation liquidation priority and participation liquidation priority, which plays an important role in balancing the interests of both parties.

3. Analysis of the Effectiveness of Liquidation Priority Clause

Liquidation priority mainly depends on the content of the contract agreement between the investor and the investee, so whether this clause has legal effect mainly depends on whether the clause itself is consistent with the content of the Contract Law, that is to say, whether the liquidation priority clause violates mandatory norms^[3]. And according to different types of trigger events, there are also great differences in the realization methods of liquidation priority.

3.1 Analysis of the effectiveness of the liquidation priority clause with the liquidation event as the trigger condition

The contents of liquidation priority clauses under such conditions are not consistent with the distribution order of liquidation property in the relevant provisions of China's Company Law. However, due to the imperfection of the Company Law, it is more difficult to identify and implement the nature of liquidation priority clauses, so it is necessary to stipulate the nature of liquidation priority clauses according to the second paragraph of Article 186 of the Company Law. In this process, relevant researchers should not only strengthen the research on legal clauses, but also clarify the normative meaning behind laws and regulations, and make clear the definition of liquidation priority clauses with reference to the practices of other enterprises and judicial practice^[4].

3.1.1 The effectiveness of liquidation priority clauses from the perspective of Company Law.

The second paragraph of Article 186 of the Company Law belongs to the scope of the company's non-bankruptcy liquidation system, which expresses the relevant contents of the property distribution order, mainly reflecting the analysis of the rights and interests of legislators and the protection of the basic interests of relevant subjects. The fundamental reason is that company liquidation involves many contents, including companies, third-party institutions and national interests, so it is necessary to strictly abide by the relevant national laws to ensure the standardization and rationality of property settlement. From this analysis, the legal provisions in the second paragraph of Article 186 of the Company Law are mandatory norms, so the liquidation priority clause does not have legal effect. However, before 2005, the legal provisions were divided into two independent contents, one of which was "when the company's property is greater than the amount of debt, it should repay a series of expenses such as wages, insurance and taxes respectively", and the other was "after the company repaid the debt, the goodwill property should be reasonably distributed according to the proportion of shareholders' "capital contribution". Formally, the two contents correspond to the two legal provisions^[5]. From the perspective of the shareholder-oriented concept, the two provisions stipulate the distribution order and proportional distribution of the company's property, so there are certain differences in their normative interests. Since the revision of the Company Law in 2005, the two legal provisions have been merged into one paragraph, and their provisions have not been revised, so they are actually two norms. That is to say, the company's surplus property stipulated in the second paragraph of Article 186 of the Company Law is only distributed reasonably to all shareholders within the company, and does not involve other interests. It is arbitrary and supplementary, and cannot be applied when the parties make another agreement in the private equity investment agreement^[6].

3.1.2 Useful reference from the perspective of the Partnership Enterprise Law

Usually, the private equity investment market is dominated by limited companies and joint-stock companies. However, when identifying the attributes of norms, the enterprise legal system should be included, and the attributes of similar legal norms in all enterprise laws should be comprehensively investigated and analyzed. From the perspective of the company's development process, the company is essentially a more standardized manifestation of the cooperative relationship between businessmen. From the legal point of view, the distribution order of the remaining property between the company's partners and shareholders is roughly the same. There are many similarities between the Company Law and the Partnership Law in the liquidation of the surplus property of the partnership enterprise. The first half of article 89 of the Partnership Enterprise Law stipulates the order of property liquidation. It involves the interests of the state and social third-party institutions, so it has the nature of mandatory norms, and the second half clarifies the principle of property distribution. It does not involve other aspects of property and interests, so it belongs to the category of partner autonomy^[7]. Therefore, when

distributing the surplus property of the partnership, the first thing is to distribute it reasonably according to the contents of the treaty. During this period, if there are doubts and unclear distribution, friendly consultations can be held. If negotiation fails, it can be deployed according to the actual situation, such as distributing the surplus property according to the proportion of capital contribution or assuming debts. Therefore, no matter which way is adopted, partners are given sufficient autonomy. Therefore, in the legal norms of the Partnership Enterprise Law, the liquidation priority clause has strong autonomy in other aspects except the limitation of the allocation quota^[8].

3.1.3 Useful references provided by foreign-related laws and legal undertakings

When the nature of the invested enterprise is a Sino-foreign joint and cooperative enterprise, Article 23 of the Sino-Foreign Cooperative Enterprise Law provides legitimacy for the liquidation priority clause. “When the Sino-foreign joint and cooperative enterprise is about to terminate its cooperation, it shall liquidate the property and debts in accordance with the relevant provisions and distribute the property.” From a formal point of view, this legal provision belongs to mandatory norms. From a substantive point of view, although this legal provision stipulates the liquidation procedure of property, it does not impose mandatory norms on its liquidation procedure, giving both parties of the contractual joint venture sufficient autonomy to distribute according to the contents of the contract. At the same time, when the invested enterprise is a Sino-foreign joint venture, Article 94 of the Regulations for the Implementation of the Law on Sino-foreign Joint Ventures provides legitimacy for the liquidation priority, which stipulates that “if a joint venture has surplus property after repaying its debts, it shall be allocated reasonably according to the proportion of its capital contribution, and if there is an agreement in advance, it shall be allocated according to the contents of the agreement”. From the formal point of view, this article does not contain the words “should”, so it does not have mandatory norms. From a substantive point of view, this legal provision stipulates the distribution order of surplus property, but gives both parties greater autonomy and can distribute it according to the prior cooperation agreement.

To sum up, the content of the legal provisions in paragraph 2 of Article 186 of China’s Company Law is regulated by two aspects. The distribution of surplus property after debt repayment in the second half is arbitrary, that is to say, the order of property distribution under liquidation priority triggered by liquidation events has legal effect, and the Company Law can be used as legal evidence for the distribution of surplus property to protect the basic rights and interests of relevant responsible persons of enterprises^[9].

3.2 Analysis of the effectiveness of the liquidation priority clause with the liquidation event as the trigger condition

First of all, we should make a detailed analysis of the legality of the clause itself and the legality of its performance. Mainly divided into two parts:

3.2.1 The liquidation priority clause triggered by “Deemed Liquidation Event” is not based on the substantive liquidation of the company.

“Deemed Liquidation Event” means that once there is a risk problem in private equity investment and the invested company appears as a liquidation event, the company can take other measures to save itself, such as merger and reorganization, so the company may not carry out the actual liquidation work, so this kind of event is called “Deemed Liquidation Event”. Once such an event occurs, investors can sell their shares within the scope permitted by law to unilaterally reduce their capital, and successfully withdraw to protect their rights and interests from damage. The emergence of this situation shows that the basis and premise of the distribution of surplus property regarded as liquidation events is not the dissolution of the company, and it is not consistent with the relevant contents of the Company Law. Academics believe that the dissolution of a company can be regarded as a condition for the liquidation event to trigger the liquidation priority, that is to say, the liquidation event can be regarded as the main reason and basis for the dissolution of an enterprise. Once the above problems occur, the remaining property can be divided according to the provisions of the prior agreement to get a return, so that the Company Law can be given legal effect as the liquidation priority under the background of the liquidation event. However, there are still some obstacles and doubts in the specific practice of this theory. The fundamental reason is that the articles of association are an important condition for the establishment of an enterprise. According to the relevant laws and regulations, once the contents of the articles of association are found to be irregular, the company should modify and adjust them. Moreover, China’s Market Supervision Administration will provide perfect and standardized model articles of association for reference, and strengthen the examination and management of the articles of association.

Therefore, some contents in the articles of association that are beneficial to the company's operation but do not meet the legal requirements cannot pass the examination of the Market Supervision Administration, so they cannot be filed. In fact, the model text of the articles of association is one of the important contents of the judicial organs in China to carry out public services, but it does not belong to the relevant legal categories, so it does not have legal effect to review the articles of association according to the model text. With the continuous development of time and the improvement of laws and regulations in China, the relevant contents of liquidation priority in the articles of association will be gradually improved, but as far as the current legal content is concerned, this theory does not have strong practical significance.

3.2.2 The legal restrictions on the performance of the terms shall not affect the validity of the contract itself.

There are great differences between the validity of the contract and the performance within the contract. The validity of a contract means that the meaning of both parties in the contract is true, and the design of the terms conforms to the legal provisions, so it has legal effect. Even if there is a liquidation event, the company can take effective measures to avoid the actual liquidation procedure, but distribute the remaining property according to the contract content on the basis of preserving the company's operation and development, for example, selling equity or repurchasing equity. However, in this case, although the Company Law is not applicable, the performance of the liquidation priority clause is still bound by the Company Law, so the relevant responsible person should consider whether the performance of the agreement conforms to the relevant laws and regulations. If there is a violation of the laws and regulations, it means that the performance of the liquidation priority clause has no legal effect.

3.3 The view of judicial practice

In China's judicial practice, there is no enterprise case regarding the effectiveness of liquidation priority under the background of liquidation events, so once it appears, we can refer to the "gambling agreement", and there are some similarities between them. 9th Conference Minutes clearly stipulates the gambling agreement. "If the gambling agreement concluded between the investor and the target company is not legally invalid, the people's court will not support it if the target company claims that the gambling agreement is invalid only on the grounds of the existence of equity repurchase or monetary compensation agreement." Therefore, taking the "gambling agreement" as a reference, the liquidation priority can be supported by laws and regulations to ensure its legal effect. In addition, the Minute of Nine Citizens clearly states that "the people's court shall review the mandatory content of share repurchase when the investor actually performs, ensure that it conforms to the provisions of the Company Law, and judge whether it can get legal support". Therefore, in the context of liquidation events, if investors want to realize the liquidation priority, they should ensure that their rights meet the requirements of relevant national laws and regulations and conform to the company's capital reduction process, otherwise even if the treaty content is standardized and effective in advance, they will not be supported by judicial practice and will not be able to realize their own litigation requirements.

4. Conclusion

To sum up, the scale and amount of private equity investment in China are increasing, and the existing market risks are gradually increasing. Therefore, it is of great significance to strengthen the analysis and research on the exit mechanism and liquidation priority wind to ensure the orderly development of China's economic market and promote the development of the country's comprehensive strength. Therefore, the thesis analyzes the concept, rationality and legal effect of liquidation priority in detail, and makes clear the implementation background and legal effect of liquidation priority from the legislative and judicial perspectives, so as to build a perfect exit path for private equity investment and lay a solid foundation for promoting the growth and development of private equity investment in China.

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