

Research on Investors' Right of First Refusal in Private Equity Investment

Xiaoya Fan^{1, a}, Ziyang Kong¹, Shini Sun¹, Ziyi Zhang¹, Deyu Li^{2, *}

¹School of Law, Anhui University of Finance and Economics, Bengbu, Anhui, China

²School of Economics, Anhui University of Finance and Economics, Bengbu, Anhui, China

^a20203913@aufe.edu.cn, * Corresponding author: ldy0048@163.com

Abstract: The right of first refusal clause for investors in private equity investment is one of the fastest terms to reach agreement between investors and the founding team in investment agreements. However, due to the complexity of transactions in practice and the imperfect relevant regulations, various conflicts and disputes such as shareholder transfer of equity and other shareholders claiming the right of first refusal often occur in practice, which not only affects the internal stability of the company but also affects the interests of third parties. Therefore, this article provides a deep analysis of the right of first refusal through its background and practical value, sorts out and analyzes the key points that may be involved in the exercise of this clause, and puts forward relevant suggestions for the improvement of the right of first refusal. This has important practical significance for both investors to better protect their own rights and interests in practice.

Keywords: Investment, Shareholder, Right of first refusal.

1. Introduction

As the Chinese economy enters a new stage, the close combination of direct financing and scientific and technological innovation attributes has become a new driving model for current economic development. Private equity investment funds, as the core capital element in direct financing, are increasingly involved in equity transactions under the development of the market economy. The right of first refusal clause is one of the terms that investors and founding teams can quickly reach agreement on in investment agreements. This makes the preemptive right in shareholder equity more important and receives more attention. The establishment and in-depth research of this system can effectively maintain the normal development of limited liability companies, maintain and balance the interests of shareholders and all parties, and thus ensure the healthy development of China's market economy on a normal track, which is of great significance. However, in the application of practical affairs, due to the incompleteness of legislation and the complexity of transaction, there are still many gaps in the application of shareholder's right of first refusal, and many issues cannot be found with appropriate legal basis, leading to many issues and controversies, making it difficult for shareholders' right of first refusal to be effectively exercised in actual life transaction.

2. The Practical Value of the Right of First Refusal

2.1. Maintain the stability of the founding team

For investors, especially venture capital, investment is the investor. One of the main investment factors that investors consider during the start-up stage of a company is the founding team, including its growth, management, and learning abilities. Therefore, investors hope that the personnel of the founding team are stable. Even if the founding team intends to transfer its equity in the company, investors also hope that such actions require written consent from the

investor, and I hope to have the right of first refusal to purchase the equity, so the investor's right of first refusal in the equity investment agreement is beneficial to the stability of the founding team to a certain extent.

2.2. Reserve the right to continuously increase investment

The right of first refusal, as one of the fundamental rights of shareholders in a company, is different from the right of first refusal under the Company Law. In practice, in many equity investment agreements, both parties explicitly grant investors the right of first refusal through an agreement in the contract, and this right is often superior to the shareholder's right of first refusal in practice. When the founding team intends to transfer part or all of their company's equity, if investors believe that the company has further investment value, they can have priority over external third parties or even other shareholders to acquire such equity, thereby increasing their shareholding in the company.

In practice, when a company raises funds, the founding team usually expresses their determination to hold long-term equity in the company in order to give investors enough confidence. Correspondingly, if the willingness of the founding team to transfer equity is extremely low, investors demand the right of first refusal, and the founding team is also more difficult to refuse. However, we still suggest that the founding team focus on the specific design of the right of first refusal clauses to achieve a relatively balanced agreement between investor requirements and equity arbitrage or liquidity.

3. Key Points of Attention in the Exercise of the Right of First Refusal

3.1. The provision of 'equal conditions' is too broad

For the right of first refusal, the term 'priority' generally refers to the priority that investors enjoy in the order of equity transfer compared to other civil subjects such as shareholders

under the same conditions, and cannot be understood as having a relative advantage in terms of transaction conditions. In judicial practice, in addition to using the quantity, price, payment method, and term of equity as the criteria for determining "equal conditions", in special circumstances, factors such as merging multiple transferors to transfer their company equity will also be considered as "equal conditions". In addition, the court will also judge that "equal conditions" are deliberately created by both parties to the transfer, The preemptive right of other shareholders can counter such transfer behavior. However, due to a large number of gaps in relevant regulations, many affairs cannot find corresponding legal basis, resulting in many events that affect the fairness of market equity transactions, such as collusion between shareholders and third parties, intentional setting of special false transfer conditions, intentional raising of prices, etc., which have infringed on the legitimate rights and interests of investors. There are also cases where investors ignore the special relationship between shareholders and third parties under the same conditions, Even by demanding a low-priced transfer of equity, it infringes on the legitimate rights and interests of shareholders and third parties, disrupts the normal order of market transactions and the unity and stability within the company. Therefore, the specific recognition of equal conditions is not only of great significance for the improvement of the law, but also for maintaining fair market transactions, safeguarding the legitimate rights and interests of investors and shareholders, and promoting the further stable development of the company.

3.2. Restrictions on investor equity transfer

Generally speaking, investment agreements explicitly stipulate that investors do not restrict the transfer of their company shares to related companies or other third parties. In this case, investors may demand a waiver of the right of first refusal.

3.3. Exclusions from the right of first refusal clause

It should be noted that the terms regarding the investor's right of first refusal should be clearly excluded: (1) Changes in equity holders due to inheritance; (2) The change in equity ownership within the company that occurs as a form of reward for motivating employees by transferring equity to outstanding employees; (3) The investor has previously approved various situations where the company undergoes equity transfer changes through written confirmation.

4. Suggestions for Improving the Exercise of the Right of First Refusal

4.1. Clarify the effectiveness of the equity transfer contract

From the above analysis and relevant judgment cases, it can be seen that there are significant differences in determining the effectiveness of this transfer contract in practical application. This theoretical debate and practical divergence reflect the hierarchical nature of the effectiveness of equity transfer. The effectiveness of equity transfer contracts is different from that of equity changes. The legal relationship of the equity transfer contract between the transferring shareholder and an external third party shall be recognized as effective from the date of its establishment in accordance with the law. After the contract is confirmed to take effect, both

parties shall fulfill their respective obligations in accordance with the contract. The effectiveness of equity changes depends on the specific relevant provisions of the contract agreement between both parties and the specific performance results of the contractual agreements. As for the contracts signed between the third party and the transferring shareholder, adjustments should be made in accordance with the relevant provisions of the Contract Law. There is a certain separation between the effectiveness of equity transfer contracts and changes in equity, and the Company Law does not exclude the application of the Contract Law.

4.2. Changes and determination of "equal conditions" in the litigation process

When exploring investors' right of first refusal, it is necessary to clarify that the premise for the existence of this right is equal trading. In the exercise of this right in litigation, as an important part of factual investigation, it is crucial to determine the conditions of equality. In general civil cases, a factual investigation must be completed before prosecution. In the case of investors' right of first refusal, requesting the right of first refusal actually leads to a game between the relevant parties claiming the right, so it is reasonable for the conditions for equity transfer to change. The Company Law of our country does not limit the final determination time of the purchase conditions, that is, the "equal conditions", which may extend the purchase conditions of the transferee to litigation proceedings, thus causing the transferee to compete with other shareholders on the purchase conditions. At this point, rejecting bids is not conducive to achieving the maximum interests of shareholders, and it also does not comply with the laws of market economy. Therefore, China's legislative and judicial departments should actively improve relevant measures to make investors' right of first refusal more operational in practical affairs.

4.3. Clarify the responsibility for abusing the right of first refusal

In the case of infringement of the investor's right of first refusal, it can be understood that the right holder exercises the right to protect their own interests and pursue the maximization of their own interests. But if the rights holder abuses their rights and maliciously prevents shareholders from transferring their equity, it will be an act of infinitely expanding the boundaries of rights. If an investor abuses their right of first refusal, it naturally violates the principle of good faith. However, China's laws do not clearly stipulate the legal responsibility of investors for abusing the right of first refusal, resulting in a reduction in the cost of abusing the right of first refusal, and to a certain extent, causing negative effects and consequences of condoning investors' abuse of their rights. The abuse of rights by rights holders not only harms the interests of the transferring shareholders and third parties, but also prevents them from receiving necessary punishment if the transferring shareholders or third parties invest a large amount of manpower and resources to achieve the purpose of equity transfer. This is clearly unfair.

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