DOI: 10.37420/j.mlr.2023.005

A Review of the Doctrinal Debate on the Determination of the Performance Commitment Compensation for Major Asset Reorganization

Fei Yin*
School of Law, Sun Yat-sen University, Guangzhou, China
***Corresponding author e-mail: acadzsu@163.com**

Abstract

Around the definition of the attributes of performance promise compensation in major asset restructuring, there are doctrines such as shooting contract theory, conditional contract theory, guarantee contract theory, option theory, etc.Although there are similarities between these doctrines and performance promise compensation, the existing doctrines under detailed examination cannot fully interpret the normative characterization of performance promise compensation.The uncertainty of the target performance is explored, which leads to the difference of subjective uncertainty between the performance promise compensation and the contract, the "performance" of the performance promise compensation and the "condition" of the conditional contract look different, the rights and obligations of the performance promise compensation and the guarantee or option contract are constructed differently, and the performance promise compensation is not a breach of contract liability as recognized in judicial practice.

Keywords

performance compensation commitment; Major asset restructuring; Property Identification

Introduction

The so-called performance promise compensation can be regarded as a valuation adjustment mechanism to some extent, and its mechanism of operation is that the investor and the financier agree in advance that if the target company does not complete the pending business performance, the investor has the right to adjust the proportion of equity in the target company or adopt other alternative ways of business effect adjustment, and vice versa. The essence of performance promise compensation is a transaction strategy adopted by the M&A party and the M&A policy on the pricing of the underlying assets. The nature of this transaction structure is more enthusiastically discussed in the private equity field, but less frequently in the field of major asset restructuring. This paper analyzes the academic debate on the attributes of performance commitment compensation in major asset restructuring in the context of the discussion on the nature of the betting agreement, which has structural similarities with the betting agreement in the field of private equity.

Doctrinal debate on the attribution of performance promise compensation

At present, most of the direct discussions on the nature of performance promise compensation are in the field of taxation, and these discussions have formed multiple opinions on the characterization of performance promise compensation from the perspective of tax treatment, however, although these doctrines have been discussed from the perspective of tax treatment, they have not formed useful explanations from the perspective of jurisprudence, and most of the existing studies are centered on private equity betting agreements.

The doctrine of the lucky shot contract

A lucky contract is a risk-based agreement with uncertain payment as the main content, and the uncertainty of the payment content mainly comes from the contractual contingency, which is typical of a lucky contract because the payment content is attributed to a contingency. The target of performance promise compensation is the uncertainty of the future performance of the enterprise, and since the business performance of the enterprise is affected by a variety of factors, it is in line with the characteristics of a lucky contract. Some scholars believe that "unforeseeable possibility" is the root cause of contractual incompleteness from the theory of incomplete contract, and compared with a complete contract with clear rights and obligations, the uncertainty of performance promise compensation is essentially an incomplete contract due to the existence of factors such as information inequality and contracting costs. The uncertainty of subsequent investment returns is not fully foreseeable by both the acquirer and the acquiree, which makes it a strong projection of luck. Even if the party to be acquired intends to actively work to meet the promised performance targets, it may not be able to achieve them all, and the subject of the contract is objectively arbitrary.

Conditional Contract Doctrine

The said statement compares the performance promise as a condition with the condition in the conditional contract and concludes that it is a conditional legal act after drawing the similarity of legal nature. A conditional legal act means "a legal act in which the parties specifically stipulate certain conditions, and the fulfillment (occurrence or appearance) or non-occurrence of the conditions is the basis for the occurrence or termination of the effect of the legal act." A condition is "a part of the expression of intent that makes the legal act occur or cease to have effect on an objective and uncertain future fact."This is because the structure of the betting agreement is consistent with the characteristics of "conditions" in a conditional contract. In the performance promise compensation, the performance promise of the acquired party is the valuation of the target company's future operation, which is based on the actual development of the target company, and coupled with the existence of uncontrollable factors such as policy and market changes, the subject of the bet can only be a probable event that may occur in the future, with obvious future and contingency. Such contingency also leads to uncertainty of legal effect, and the performance compensation clause will be triggered only when the agreed performance commitment conditions are not fulfilled, in line with the basic characteristics of conditional contracts. It is under this similar construction that the betting mechanism is considered to be close to a conditional contract.

Security Contract Doctrine

A security contract is an agreement negotiated between the parties to ensure the realization of the creditor's claim in some way when the debtor fails or is unable to perform the debt, and the security contract is a subordinate contract dependent on the main contract. The guarantee contract says that the betting agreement is dependent on the investment agreement and is a subsidiary agreement of the investment agreement, and even if the betting agreement exists separately, it does not change its subordination. In the betting agreement, both parties agree to compensate the investor when the target performance is not achieved, so the betting agreement can be regarded as an implicit guarantee system.

Option Doctrine

The option contract is a right contract with the characteristics of option and formation right, and the right holder can choose to exercise the option after the expiration of the option or abandon the exercise of the option. The option says that the betting agreement is also an option to a certain extent, because the investor can profit from the appreciation of shares after the target performance of the underlying enterprise is completed, which is equivalent to the option purchaser executing the option at a favorable price to obtain income; when the target performance of the underlying enterprise is not completed, the compensation implemented by the performance commitment to the investor is also similar to the hedging function of the option. Whether the financier achieves the promised performance targets or fails to do so, the investor either receives an increase in share value or compensation for the commitment, which is essentially a zero-sum game with an imbalance of rights and obligations. The difference is that the execution of the betting agreement needs to be executed on the agreed expiration date and regardless of the operating condition of the underlying enterprise, and the investor's profit as an option holder will change according to the performance of the financier.Therefore, if the betting agreement is compared to an option contract, it has a similar function of hedging and value preservation compared with other financial derivatives.

Review of the doctrine on the attribution of performance promise compensation

Although a series of discussions on the nature of the betting mechanism centered on the betting mechanism have been made in China's academic circles, which to a certain extent can serve as a useful viewpoint to identify the nature of performance promise compensation, the doctrines still have certain omissions and are not sufficient to comprehensively define the nature of performance promise compensation.

Differences in subjective uncertainty between performance promise compensation and shooting good contracts

Although there are structural similarities between the performance promise compensation and the shooting contract, it is not beneficial to the nature of the performance promise compensation and the application of the rules. Because of the unequal rights and obligations of the performance contract and the deviation from the

principle of equivalence, the legal validity of the performance contract is subject to stricter control, and it has been pointed out that the performance contract should be invalid in principle except for the explicit provisions of laws and regulations. In the absence of a clear legal basis for the contract, I am afraid that defining the performance promise compensation as a contract of luck is not beneficial to the argument of its legality. Secondly, there is a big difference between the uncertainty of the contract of shooting luck and the uncertainty of the compensation of performance promise, which generally does not change due to the subjective will of the parties, and even if there is some correlation, it is a lower degree of correlation. The target performance promised in the performance promise compensation, although affected by objective market and policy changes, also depends to a large extent on the subjective will of the management of the target company.Generally speaking, the performance compensation agreement will use a combination of rewards and punishments to play a binding incentive role on the management of the acquired party and strengthen the management's faithful and diligent obligations, so whether the performance commitment can be achieved depends largely on the management ability of the target company. Thus, the betting target of performance promise compensation is not only affected by objective factors, but also depends to a large extent on the subjective factors of the parties. Again, the subject matter of the contract is only a subjective "hope", and the willingness to deal is subjective and arbitrary,The difference is that in the performance compensation agreement, the M&A party invests not only in a "hope" but also in a rational investment choice made carefully after comprehensive consideration, aiming to make profits through investment, unlike the subjective arbitrariness of the parties' willingness to deal in the shooting contract.Finally, it is pointed out that the kernel of the contract is that one party is "only take no" and the other party is "only give no", and both parties have the same possibility of "only take no" or "only give no". "However, from the point of view of the whole transaction chain of the performance promise compensation, the transaction between the two parties has the equivalence. If we restrict the view to the performance promise compensation of the acquired party, there is indeed the inequity of the M&A party's "take only", but if we extend the view to the whole transaction structure of the major asset reorganization, we will find that the performance promise compensation is only a corrective measure for the wrong valuation of the target enterprise, and the performance promise compensation precisely plays the function of facilitating fair trade. The performance promise compensation functions precisely as a facilitator of arm's length transactions. Therefore, it is not appropriate to consider the performance promise compensation as a shooting luck contract, and judicial practice also recognizes that the reasonableness of the betting transaction model lies in the performance compensation as an integral part of the transaction consideration, which is different from the imbalance of risk in the shooting luck contract.

The "performance" of the performance promise compensation and the "conditions" of the conditional contract look different

The future operating results in the performance promise compensation and the "conditions" in the conditional contract also look different. The primary difference between the two is the timing of the agreement's entry into force. The core of a conditional contract is that the contingency of the establishment of the condition affects the validity of the contract, and the contract does not take effect when the condition has not been fulfilled, so the contract is not effective even though it is established. The compensation for performance commitment, whether as a provision of a major asset reorganization contract or as a separate agreement, becomes effective when the parties sign and seal it without special agreement, and the applicable rule is Article 136 of the Civil

Code, "A civil legal act becomes effective when it is established, unless otherwise provided by law or agreed by the parties. " It can be seen that the performance promise compensation in the major asset restructuring contract as an agreed condition does not affect the validity of the legal act, and there is a significant difference from the conditional legal act under Article 158 of the Civil Code. Another significant difference lies in the subject matter of the conditions attached, "the conditions attached to the contract with effective conditions are not the subject matter of the contract, but only the conditions that determine whether the contract is effective or not, and the subject matter of the contract is definite, while the future business performance with uncertainty agreed in the betting agreement is the subject matter of the contract, not the conditions that determine whether the contract is effective or not. ". Of course, some scholars believe that although the attached conditions are basically directly related to the subject matter of the contract, but it does not follow that the overlap of the conditions and the subject matter does not belong to the contract with conditional effect, when the conditions and the subject matter overlap the agreed matters have the dual attributes of the subject matter and conditions. In fact, the important difference here is that the conditional contract is a restriction with conditions attached to the legal act itself, while the performance promise compensation is a condition attached to the content of the rights and obligations of the legal act, which is really not the same level.

Performance promise compensation has a different structure of rights and obligations than guarantee or option contracts

In the case of guarantee, the creditor and the guarantor occur in a creditor-debt relationship aimed at ensuring that the claim is satisfied, and the relationship underlying the performance commitment compensation is an investment relationship between the investment and financing parties, which is aimed at reducing the investment risk of the investor. In this way, the guarantee relationship is either the debtor or a third party with its specific object or right as the subject of guarantee, or a third party with guarantee liability, i.e., the guarantee relationship is a credit enhancement measure with specific property interest or the credit of a third party as a guarantee for the claim. The performance commitment compensation is not secured by a specific property interest of the financier, but is a cash compensation or equity compensation to the investor if the target company fails to meet the performance target, and there is an essential difference in the structure of rights and obligations. It is further argued that such valuation adjustment mechanism is not a guarantee clause, and the effect of the M&A party's drought-protected income through the compensation clause is often an illusion, as the M&A party has a large amount of implicit investment, so there is no guarantee problem.In the case of options, the M&A party in the performance commitment compensation does not have the right to freely choose, and the exercise of the M&A party's right depends on the achievement of the performance target. Since the achievement of the target performance is an external condition for the exercise of the investor's right, the M&A party's right to exercise is not out of choice. In addition, the pricing of the option in the option contract is generally determined at the time of contract signing, while the pricing of the target company in the performance commitment compensation is required to be based on the performance indicators, and thus only after the expiration of the period agreed in the restructuring contract based on the actual performance.

Performance promise compensation is not a breach of contract liability as recognized in judicial practice

Judicial practice also links performance promise compensation with breach of contract liability, holding that performance compensation payments have the nature of liability for damages due to breach of contract. More views consider the performance compensation payment as liquidated damages. For example, some courts have held that performance compensation payments are compensation payments set by the promisor for failing to meet the profit target, which are in line with the legal characteristics of liquidated damages in nature. Alternatively, it is considered that the performance compensation belongs to the calculation method of damages agreed by both parties and has the nature of liquidated damages. It is important to understand that liquidated damages are the parties' pre-agreed liability for subsequent breach of contract, which is both predetermined and contractual in nature. As an alternative or transformation of contractual debt, liquidated damages are based on contractual debt, and no debt means no liquidated damages, and the two have the same nature. However, the purpose of performance promise compensation is not a transformation of contractual debt, which is originally a contractual debt itself, and the purpose of this debt is to require the M&A to return the difference in price based on the promised performance to the M&A party, thus excluding the uncertainty factor of pricing in the asset restructuring process. It is for this reason that the performance compensation clause is not based on a breach of contract and is not liquidated damages in nature. In practice, if the performance promise compensation is considered as liquidated damages, the M&A party will have the right to adjust the amount of performance compensation according to the liquidated damages discretionary clause, and the payment of performance compensation will be restricted by the excessive liquidated damages, which will make it difficult to exclude the function of pricing uncertainty in the restructuring process, and the rights and interests of the M&A party will not be protected, and I am afraid that it will have side effects on restructuring financing. The basis of the performance promise compensation is the fair price of the target company's equity, allowing the M&A party to reduce the amount of performance compensation through the liquidated damages discretion clause will encourage the M&A party to exaggerate the target company's performance, further promoting dishonest behavior, and therefore should not support the defense that the performance compensation payment is too high and needs to be reduced.Some courts have clearly pointed out that the parties only have the right to request the court to reduce the abnormally high liquidated damages with reference to the actual loss, and the cash compensation as a contractual obligation should not only be performed by the parties strictly in accordance with the contract, but also the court should not interfere with it arbitrarily, and the performance compensation is a commercial judgment made by the parties based on a lot of experience in commercial activities, and the court should respect the autonomy of the parties within the legal limits of commercial activities, and should not support the request for intervention due to the performance agreement The court should respect the autonomy of the parties within the legal limits of commercial activities, and should not support the request for intervention because the performance agreement is detached from the actual operation of the enterprise, the average profit rate of the industry and the overall economic trend.

Conclusion

The nature of performance promise compensation in the field of major asset restructuring is still debated, and the various doctrines currently proposed around the betting agreement cannot be directly applied to perfor-

mance promise compensation. This paper argues that the key to the definition of the nature of performance promise compensation lies in the understanding of the uncertainty of the target performance, which is the core legal feature of performance promise compensation, so that it can be analyzed that the subjective uncertainty of achieving performance is different from the subjective uncertainty of shooting luck, and the performance condition is not a "condition" as referred to in the conditional legal act, and is different from the construction of guarantee or option. The performance condition is not a "condition" in the sense of a conditional legal act and is not the same as a guarantee or an option, let alone a liability for breach of contract.

References

[1] Zhang Xianzhong. (2013). "Research on Valuation Adjustment Mechanism in Private Equity Investment - A Perspective on Capital Regulation of China's <Company Law>" in Law Forum, No. 5.

[2] Xie Haixia, "An Analysis of the Legal Nature of Betting Agreements," in Journal of Law, Vol. 4, 2010.

[3] Hu Xiaoke. (2011). "Study on the Enforceability of "Betting Agreements" in the Field of Venture Capital", in Securities Market Herald, No. 9

[4] Fu Dou. (2011). "The Legal Construction and Qualitative Observation of Betting Agreements", in Political Law Series, No. 6

[5] Shi Shangkuan, (2011). General Theory of Civil Law, China University of Political Science and Law Press, p. 473.

[6] Qiang Li (2011). "The Nature and Effectiveness of Betting Provisions in Private Equity Investments," in China Trial, No. 12.

[7] Chen Chaoyi. (2017). "Analysis of the Legal Effectiveness of the Betting Agreement and Institutional Construction", Doctoral dissertation, China University of Political Science and Law, p. 51.

[8] Li Yan. (2009). "Discussion of the Legal Attributes of the Betting Agreement", in Financial Law Court, No. 1.

[9] Bing Liu and Mingguo Yang. (2009). "Valuation Adjustment Agreements for Corporate Mergers and Acquisitions Based on Option Theory," in Modern Management Science, No. 11.

[10] Fu Wang. (2013). "Rethinking the Effectiveness of PE Valuation Adjustment Agreements: The "Blocking" and "Unblocking" of Valuation Adjustment Agreements from the Case of Gansu Shibai "Willing to Bet but Not to Lose", in The "blocking" and "unblocking" of valuation adjustment agreement from the case of Gansu Shibai "willing to bet to lose", in Securities Law Court, vol. 8.

[11] Lin Cheng Er (2003). "General Theory of Civil Law Debt - A Systematic Explanation", People's University of China Press, p. 33.

[12] Huang Feng, "The Contract of Luck and Derivative Financial Work Transactions", in Yang Zhenshan, ed. 597.

[13] Pan Lin. (2013). "Financial Innovation and Judicial Decisions: A Sample of Cases, Doctrines and Practices of "Betting Agreements" in China", Nanjing Normal University Journal (Social Science Edition), No. 3.

[14] Hua Yixin (2015). "Analysis of the Nature and Effectiveness of the Betting Agreement - From the Perspective of and ," in Journal of Fuzhou University (Philosophy and Social Science Edition), No. 1.

[15] Fu Dou. (2011). "Legal Construction and Qualitative Observation of the Betting Agreement," in Political Law Series, No. 6.

[16] Wang Zhen. (2013). "Economic Analysis of the Legal Nature of the Betting Agreement and its Effective-

ness Analysis", in Gansu Finance, No. 5.
[17] Ren Yongfei and Ding Yong. (2019). "The Legal Application of Valuation Adjustment Agreements," in People's Justice - Applications, No. 4.
[18] Yao Mingbin. (2017). "Commentary on Article 114 of (Agreement on Liquidated Damages)," in Jurist, No. 5.