THE NORMATIVE APPROACH OF THE LOCALIZATION OF PERFORMANCE COMMITMENT MECHANISM IN CHINA'S CORPORATE MERGERS AND ACQUISITIONS

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The performance commitment mechanism is widely used in capital operations in China's A-share market. As of January 2025, 88 percent of the companies listed on China's A-share market have participated in some kind of performance commitment arrangement.[1] The performance commitment mechanism, developed and deeply rooted in Chinese markets and systems, has several distinctive features. It plays a positive role in solving the problem of information asymmetry, strengthening the market credit mechanism, and avoiding tunneling. However, it also leads to some corporate governance issues. It is not uncommon to observe 'goodwill impairment'[2] and 'business performance plunge'[3] after the target company 'meets the preset targets precisely'[4] during the commitment period. There are many disputes and battles between the promisor and the promisee over the control of the target company during the commitment period, which also affects the safety and stability of the capital market. To this end, it is necessary to conduct research on the legal norms of this mechanism based on the reality of China, combining overseas experiences with China's existing business practices, regulatory systems, and traditional legal culture. This paper argues that such research should not be confined to a single legal discipline. Instead, it shall face up to the fact that performance commitment agreement has dual attributes of the contract law and the organizational law. It is essential to clarify the roles and power allocation of the promisor and the promisee within corporate governance and to regulate their conduct within legal frameworks. Such an approach not only ensures that the performance commitment mechanism functions effectively but also contributes to the advancement and refinement of legal theory, thereby facilitating the development of China's independent knowledge

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1 According to the data compiled by the author from iFinD, as of January 31, 2025, there are 5,395 companies listed on China's A-share market, of which 4,764 listed companies have issued announcements regarding performance commitments.

2 'Goodwill impairment' means that the goodwill of the company is seriously impaired and thus leads to profit loss.

3 'Business performance plunge' means that the performance targets are achieved within the commitment period, but there is a great decline in the company's business performance after the commitment period expires.

4 'Meeting the performance targets precisely' means that the targets are achieved 100% or 110%, equal to or slightly higher than the preset performance targets.

system of legal science and supporting the construction of Chinese modernization.

I. ORIGINS OF THE PERFORMANCE COMMITMENT MECHANISM IN CHINA

A. Relationship Between Corporate M&A and Performance Commitments

Despite the repeated use in regulatory documents regarding corporate mergers and acquisitions (M&A) in China, the definition of 'performance commitment' is unclear. In general, there are three interpretations of 'performance commitment' in academia. In a narrow sense, the term applies only to the compulsory performance compensation in the material asset restructurings of listed companies. From a wider perspective, it refers to the performance compensation arrangements in corporate M&A, including voluntary and compulsory compensation. In a broad sense, it includes the performance compensation arrangements in both private equity and corporate M&A. This paper argues that the 'performance commitments' in private equity and corporate M&A differ greatly and should be distinguished in theoretical research. Following the *Minutes of the National Courts' Civil and Commercial Trial Work Conference* (hereinafter referred to as the Minutes),[5] this paper adopts the term 'VAM agreement' for performance commitments in private equity, while 'performance commitments' will specifically refer to those in corporate M&A.

In the field of corporate M&A, performance commitment is mainly used to address information asymmetry and uncertainty of the future development of the target company, which helps with the transaction pricing in M&A. Unlike standard equity and asset transfer, corporate M&A are characterized by the transfer of control of the target company. This means the transfer of the benefits of control, leading to a control premium in M&A deals, which makes the valuation of the target company even more difficult. In the M&A market, the valuation of a company is usually determined by its profitability. However, due to information asymmetry between the transaction parties and the unpredictability of future development, popular accounting valuation methods in the market (such as the price-to-earnings ratio method, the discounted cash flow method, the market comparison method, etc.) are unable to make accurate

5 Part II, article (I) of the *Minutes of the National Courts' Civil and Commercial Trial Work Conference* issued by the Supreme People's Court in 2019.

predictions about a company's future profitability, making it difficult for the parties to reach a consensus on the pricing of the target company. To solve this issue, a new transaction mechanism has been created in M&A practice, by which the acquired party (the promisor) makes a commitment to the target company's net profit and other performance during the commitment period, and the cash value of the company is calculated based on such commitment. If the predetermined targets are not achieved, the acquiring party (the promisee) has the right to ask the promisor to provide compensation to bridge the valuation gap. This is how the performance commitment mechanism works.

Nevertheless, the rapid development of performance commitments in China cannot be solely attributed to the above factors. A careful study of China's M&A market and institutional environment reveals that the prevalence of performance commitment mechanism in China ultimately stems from the contradiction between market development demand and insufficient supply of legal infrastructure. High market demands have driven the innovation in VAM. China is experiencing a critical stage of transformation and upgrading of traditional industries, and companies in cyclical industries such as energy, mining, and machinery manufacturing are faced with a wave of M&A. However, in the process of industrial structure transformation, the fluctuations in economic conditions have brought difficulties to company valuation. Moreover, M&A deals in the areas of internet, biomedicine, and finance increasingly grow with the rapid development of strategic emerging industries. Due to the fundamental difference in the valuation system between the emerging industries and traditional manufacturing sector, traditional valuation methods fail to meet the various needs in the new economic environment. Under this circumstance, both the market and companies call for a more flexible and 'softer' way to adapt to the changes, so as to address the pricing issues in M&A deals.

Additionally, the Chinese market requires diversified financing and investment tools and flexible institutional supply. In overseas M&A deals, parties to the transaction can adopt financial tools such as convertible preferred shares and convertible bonds to reach flexible and complicated transaction arrangements, meeting various needs of financing and investment and development of companies. However, those complicated financial tools are not fully utilized due to legal and regulatory restrictions. Moreover, investor protection clauses commonly used in overseas market, such as liquidation preference clause and redemption right clause, are debatable in terms of their effectiveness and enforceability under the *Company Law of the People's Republic of China* (hereinafter referred to as the Company Law).

Under such circumstances, it is necessary to find another way for enterprises and investors and create a new mechanism of interest protection and risk allocation, namely, the performance commitment mechanism.

B. Characteristics of the Performance Commitment Mechanism in China's Corporate M&A

The performance commitment mechanism in China's corporate M&A has distinctive local characteristics. From a historical perspective, the origin of China's performance commitment mechanism is closely related to the regulatory requirements for related-party transactions of listed companies during the process of shareholder structure reform. To prevent unusually high premium in M&A, the exchange specified that if the shareholders holding non-tradable shares sold assets to the listed company, the parties should set pre-specified performance targets for the target asset in the following three years; and the shareholders holding non-tradable shares should compensate the shareholders holding tradable shares in cash or equity if the targets were not met.[6] The *Measures for the Administration of the Material Asset Restructurings of Listed Companies* (hereinafter referred to as the Measures for Restructurings) issued in 2008 officially introduced the performance commitment mechanism, prescribing that when the listed company acquires assets, if the transaction pricing is based on the future profits forecast, the parties should sign an agreement in advance to specify that the seller of the assets should compensate the listed company in terms of the difference between the actual profits and the expected profits. However, the China Securities Regulatory Commission (hereinafter referred to as the CSRC) revised the Measures for Restructurings in 2014 and narrowed the application scope of mandatory performance commitment mechanism. It stipulates that listed companies shall sign performance commitment agreements when purchasing assets from their controlling shareholders and actual controllers; whereas in other scenarios, the parties may decide whether to sign such agreements through free negotiation. This stipulation has been retained in the current effective version.[7] Therefore, due to the path dependence effect, China's performance commitments present a dual characteristic combining 'mandatory' and 'voluntary' nature. The mandatory performance

6 Article 14 of the *Guidelines of Shenzhen Stock Exchange for the Administration of the Covenants of Shareholder Structure Reform*.

7 Article 35 of the *Measures for the Administration of the Material Asset Restructurings of Listed Companies (2023 Revision)*.

commitment mechanism comes from the mandatory rules of the CSRC, and its main purpose is to prevent high valuation premium of related-party transactions and protect the interests of public investors; while the voluntary performance commitment is a contractual arrangement voluntarily reached by the transaction parties, aiming at reducing information asymmetry, sending positive messages, and motivating the corporate management.

The performance commitment mechanism in China also has distinctive features compared with regular overseas VAM such as redemption rights and earn-out payment. The goal of redemption rights is to ensure the exit channels for investors, allowing them to recover their costs and exit the company when the performance is not good. In contrast, the performance commitment mechanism occurs in the transaction of corporate control. Regardless of whether the agreed performance targets are achieved, control will belong to the acquiring party after the end of the commitment period. An earn-out payment is a payment arrangement in an M&A transaction that allows the buyer to pay (or not pay) the remaining amount within a certain period after the completion of the transaction based on the target company's performance, rather than paying the entire purchase price on the closing date.[8] However, in the performance commitment mechanism, all the consideration should be paid in full amount upon delivery, and the subsequent compensation can be regarded as returning the previous payment. In practice, compensation in cash is more common than in stock. In general, unlike overseas VAM, China's performance commitments adopt a unique way of combining 'high premium payment at the early stage' and 'cash compensation at the late stage'. One possible reason is that Chinese companies have stronger needs for the promptness of capital. In addition, due to traditional business mindset and current market development, payment in cash might be a faster and more effective way of interest adjustment in China than share repurchase.

II. OBSERVATION OF THE NATURE OF PERFORMANCE COMMITMENTS: PERSPECTIVES FROM BOTH THE CONTRACT LAW AND THE ORGANIZATIONAL LAW

The performance commitment mechanism is implemented through performance commitment agreements. Unlike regular commercial contracts,

8 Ninon Kohers & James Ang, *Earnouts in Mergers: Agreeing to Disagree and Agreeing to Stay*, 3 The Journal of Business 445, 447-448 (2000).

performance commitment agreements involve the arrangement of rights and obligations from both the contract law and the organizational law. The former mainly involves the arrangement of valuation adjustment in M&A deals, while the latter allocates the control of the target company in the commitment period. To prevent the distortion and negative spillover effect of performance commitment mechanism, analysis and research should be conducted from both the contract law and the organizational law perspectives.

A. Characteristics of Performance Commitments from the Contract Law Perspective

In nature, the performance commitment agreement is a private contract. It is related to yet independent from the M&A agreement. If performance commitment clauses are included in the M&A agreement, forming a mixed contract, these clauses should be separate from other clauses and assessed independently. A performance commitment agreement mainly includes two aspects: the payment obligation when the targets are unmet, specified by the performance compensation clauses; and the distribution of the control of the target company during the commitment period, prescribed in the corporate governance clauses.

Performance compensation clauses specify the payment obligation of the promisor when the predetermined targets are not met, which mainly include two parts. The first is the triggering conditions, such as the selection of the performance indicators, the duration of the commitment period, and the calculation and determination criteria of whether the targets are met. The second is how the compensation obligation shall be fulfilled, such as the ways of compensation (in cash or stock) and the amount of the compensation. Prescribing compensation obligation is a major way to manage risks and adjust interests under the performance commitment mechanism, which plays the role of risk guarantee. This clause demonstrates the core function of performance commitment mechanism in the economic aspect, that is, as a VAM, it bridges the valuation gap through post-adjustment of economic benefits, clarifies the allocation of interests and risks of the parties involved, and ensures fair and reasonable transaction consideration.

In general, performance compensation clauses mainly prescribe the payment obligation on the contractual level. Particularly, there is a triggering condition for the promisor to fulfill its obligation, that is, only when 'the pre-specified performance targets are not met', the promisor shall fulfill its obligation to compensate. It should be noted that conditional performance of contractual obligations is different from conditional effectiveness of a contract.[9] Nonfulfillment of the performance targets is not the condition for the contract to come into force, but a condition for the promisor to fulfill its compensation obligation. Although the *Civil Code of the People's Republic of China* (hereinafter referred to as the Civil Code) only covers the conditions for a contract to come into force (or become invalid) and does not specify rules for conditional performance of contractual obligations, it can be applied by analogy and relevant disputes can be resolved by referring to the relevant provisions of the former.[10] In practice, some argue that performance compensation clauses set the obligation of reaching the performance targets. When the targets are not met, the promisor constitutes a breach of contract, and targets reached through illicit means constitute a defective performance of the contract. This paper disagrees with this opinion, as the contents of the commitment are to provide compensation when the performance targets are not met, rather than guaranteeing that the targets will be reached for certain. From the view of legal consequences, unmet performance targets will not lead to the liability for breach of contract. Instead, it triggers the compensation obligation of the promisor. Moreover, the promisor can assert performance defenses (such as force majeure). Therefore, performance compensation clauses should be recognized as clauses subject to conditional performance.

Corporate governance clauses prescribe the distribution of control in the target company during the commitment period, showing the characteristics of both the contract law and the organizational law. The clauses mainly address two key issues. The first one is whether the promisor can continue to participate in the operations and management of the target company during the commitment period, so as to promote the fulfillment of the performance targets. For this, corporate governance clauses normally provide that the promisor should be employed as a director or senior executive of the target company during the commitment period, thereby controlling the operations of the target company. The second issue is to what extent the promisee, after becoming the controlling shareholder, can interfere with the target company's operations and management. For this, the clauses specify that the promisee should not interfere with the regular operations of the target company by the promisor, or prevent the fulfillment of the predetermined performance targets through illicit means. It may also be agreed that the

9 Cui Jianyuan, *Contract Term Subject to Certain Conditions Is Not Contract Subject to Time Period*, 7 Academic Journal of Zhongzhou 44, 44-46 (2017).

10 Articles 158 and 159 of the *Civil Code of the People's Republic of China*.

promisee has the obligation to provide reasonable support and cooperate with the target company's operations and development. In other words, corporate governance clauses mainly adjust the distribution of administrative interests of the two parties in the target company.

Unlike regular contract provisions, corporate governance clauses are unique as they have characteristics of involving organizational acts, concerning third parties, and having long-term effects. They make profound impacts on the stable operations and establishment of the internal power balance mechanism of the target company. In essence, this clause is a re-distribution of power in the target company. This kind of contract that adjusts the internal governance relationship during the company's operations is called a 'governance contract' by Chinese scholars.[11] In addition to meeting the requirements of the establishment and effectiveness of the contract, this type of contract should be implemented in the AOA, company resolutions, or other company documents to be effective in terms of the organizational law. The emergence of governance contracts illustrates the blurring boundary between the contract law and the organizational law, reflecting a trend of 'the contract law encroaching upon the organizational law'.[12] Therefore, the analysis of corporate governance clauses should not be limited to the perspective of the contract law but should be combined with the perspective of the organizational law, focusing on the corporate governance issues contained in it and seeking solutions in the company law.

B. Performance Commitments' Characteristics of the Organizational Law and Corporate Governance Risks

In view of the organizational law, the core issue involved in the performance commitment mechanism is the distribution and regulation of the control and power of the target company. Corporate control, a concept derived from the bundle of rights of 'corporate ownership', can be divided into various types of functions or parts, which will be distributed and transferred within different holders such as shareholders' meeting and corporate management. Following the trajectory of the development of modern companies, the division of corporate control includes two aspects. The first one is the separation of the corporate's 'ownership' and

11 Jiang Daxing, *Space for Contract in Company Law — The Logic from Contract Law to Organizational Law*, 4 Law Science 135, 142 (2017).

12 Li An'an & Hou Zixuan, *Corporate Law Adjustment of Contractual Equity Structure: An Interpretive Framework of Responsive Law*, 5 Theory Monthly 128, 129 (2022).

'management', that is, power distribution between the owner of the corporate (shareholders) and the operator (the management). Since the mid-19th century, as the size of companies grows and management becomes more difficult, the traditional model, of which shareholders manage the company, cannot adapt to the developing needs of modern companies, and there comes the separation of ownership and management. In this way, the shareholders employ professionals to serve as the management (directors or senior executives) to run the company. As a result, shareholders who provide capital only enjoy residual control and property rights. This also leads to the problem of agency costs. The second one is the power distribution within the operators (the management), which is manifested in the division of power between directors and senior executives. Since the 1980s, with the further expansion of the company's scale and the refinement of the professional division of labor, senior executives and directors began to function differently. Senior executives are responsible for operating the company, while the board of directors only provides guidance or oversees the company. The so-called 'reversal of control' has emerged.[13]

During the commitment period, the promisor and the promisee might battle for the control of the target company for their own interests. In practice, recent cases involving performance commitments in Chinese capital markets show that the battle of the parties mainly focuses on the right to appoint and dismiss the management of the target company, especially senior executives such as the general manager and finance executive. In theory, the promisee, as the new controlling shareholder, has the right to appoint the management after completing the takeover. However, the promisor generally would be required to take positions of directors or senior executives during the commitment period, aiming to ensure that the target company continues to operate smoothly and prevent the promisee from triggering the fulfillment of compensation obligation due to intentional or unintentional poor management of the target company. Whereas the promisee, in exchange for the promisor's commitment of high compensation, is willing to compromise and agree that the promisor will continue to manage the company during the commitment period; at the same time, it also gives the promisee a transition period to familiarize with the company's operations and management. To mitigate the conflicts of interest and facilitate the transaction, the promisor and promisee agree to sign the corporate governance clauses.

13 Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 William and Mary Law Review 1597, 1615-1616 (2005).

Due to the arrangement of the corporate governance clauses, there is a reversal of control in the target company during the commitment period. That is, the actual control (the rights and power to manage the company) of the target company is in the hands of the promisor who serves as senior executive; while the promisee, despite its controlling shares, does not enjoy the rights or power to run and manage the target company. As a representative example of the 'separation of ownership and management', the agency costs of the company surge. In other words, the performance commitment mechanism involves a crisis of trust and self-interest risks. The performance compensation clause protects the interests of the promisee (the shareholder), while the corporate governance clause puts the actual control in the hands of the promisor (the management), bringing doubt and mistrust into the 'shareholder-management' relationship. Moreover, the performance of the target company determines whether compensation obligation is triggered, which is closely related to the interests of both the promisor and the promisee. Both parties are highly motivated to improperly manipulate the operations of the company.

To avoid the compensation, the promisor might conduct earnings management,[14] by which the target company will 'meet the performance target precisely' in terms of its financial performance in the short term. However, this is done by 'overdrawing' its future profits, and its actual operations may fall short of the goals, leading to serious goodwill impairment and net profit plunge in future. In recent years, while implementing the performance commitment arrangement, listed companies have seen a negative spillover effect, with frequent occurrences of goodwill impairment and business performance plunge. This may have a negative impact on the stable operations of the capital markets.[15]

On the other hand, the promisee may become passive and lazy to obtain compensation, or even abuse its shareholder rights to maliciously hinder the achievement of performance commitment targets. In judicial practice, disputes arising from this are prevalent. While dealing with such cases, regulators and judges tend to make analyses and decisions from the perspective of the contract law. Therefore, it is necessary to clarify

14 Earnings management includes earnings manipulation and earnings fraud. Earnings manipulation refers to the corporate management, abiding by the accounting rules and company law, using the accounting choice flexibly to achieve its purpose or results to affect earnings, or manipulating earnings through actual operations and transactions without harming the company's value. Earnings fraud means the corporate management manipulates earnings by violating accounting rules and company law, or through actual acts that harm the company's value.

15 Luo Zhenji, *Fulfillment of Restructuring Performance Commitments of Listed Companies in Shenzhen Market and Supervision Suggestions*, 11 Securities Market Herald 68, 69 (2021).

the positions, rights, and obligations of both parties from the perspective of corporate governance, so as to balance the interests of each party and safeguard the healthy and stable development of the capital markets.

III. ALLOCATION AND REGULATION OF THE MANAGEMENT POWER OF THE PROMISOR DURING THE PERFORMANCE COMMITMENT PERIOD

The power of management in a company can be defined in narrow and broad terms. In a narrow sense, the management's power refers to the rights and power to manage the internal affairs of the company; in a broad sense, it also includes the rights to represent the company when conducting business with outsiders and to sue on the behalf of the company.[16] The corporate governance clause is mainly designed for the management power in the narrow sense, which includes the rights and power to possess, use, benefit from, and dispose of the property and resources of the company. According to the arrangement of the corporate governance clauses, the promisor should be designated as part of the management of the target company, and thus enjoy the management power during the commitment period. Therefore, the actions of the promisor should be legally regulated.

A. The Granting, Exercise and Protection of the Promisor's Management Power

The corporate governance clauses entitled the promisor with the management power to maximize the use of the promisor's human resources, motivate them to use their expertise and play their role in full, and ensure the smooth and stable operations of the company. Moreover, according to the principle of reciprocity of rights and obligations, the promisor's compensation obligation is based on its management power. Only by enjoying the management power can it be sensible and reasonable for the promisor to bear the compensation obligation when the company performs poorly. This paper argues that the management power of the promisor, based on the corporate governance clauses, has its special characteristics compared with regular management power.

16 There is a theoretical dispute over whether the power of the management is essentially 'power' or 'rights'. This article argues that 'rights' generally refer to specific interests recognized and protected by law; however, the power of the management is characterized by dominant influence, and there is a certain degree of domination relationship between the management and the company, which is more similar to the concept of power.

Firstly, regarding the granting of power, the promisor will not automatically obtain the management power of the target company after the corporate governance clauses become effective. Instead, they can only obtain and exercise the management power after being appointed as the management through company resolutions. Based on the Company Law, directors are selected by the shareholders' meeting while senior executives are employed by the board of directors. The shareholders' meeting or the board of directors abstracts the intention of their members into the intention of the company through meeting resolutions, which then becomes the legitimate basis for the promisor to obtain the management power. However, scholars' opinions differ as to whether the resolution itself can have the legal effect of authorizing the management power, or whether it must go through a separate authorization process.[17] This paper argues that because the sources of power enjoyed by directors and senior executives are different, the procedural requirements for granting power should also be different. As to the sources of directors' power, three theories exist: legal authorization, shareholder authorization, and contract authorization.[18] Article 67 of the Company Law lists nine functions of the board of directors and allows the AOA to expand the functions upon them. Hence, the theory of legal authorization is more suitable considering the current regulations in China. In other words, the management power of directors is authorized by law and the AOA, and the authorization of a director's power is a unilateral legal act involving a counterparty in its legal nature. Therefore, if the promisor takes the position of director, it obtains the management power after being appointed as a director through corresponding resolution procedures. However, unlike the power of directors, the Company Law revised in 2023 deleted the specific rules of the power of senior executives, specifying that senior executives shall perform their functions and powers authorized by the board of directors or provisions of the AOA. Precedents in China also suggest that the authorization of senior executives' power is an authorization by conduct rather than by law.[19] Essentially, the management power enjoyed

17 Liu Yusheng, *Qualification and Powers of Corporate Managers*, 21 Law Forum 16, 20 (2003).

18 Legal authorization theory believes that the power of a company is authorized by law, and thus the power of the board of directors also comes from legal authorization. Shareholder authorization theory argues that a company, by nature, is the collection of the shareholders' property, and thereby the power of the board of directors is authorized by shareholders. As to the contract authorization theory, a company is essentially a collection of a series of contracts, and therefore the power of the board of directors comes from the agreement. *See* TANG JUN, RESEARCH ON THE POWER DISTRIBUTION OF LISTED COMPANIES: FROM THE PERSPECTIVE OF THE DISPUTE BETWEEN SHAREHOLDER CENTRALISM AND BOARD CENTRALISM, at 67-69 (Law Press・China, 2019).

19 Li Jianwei & Li Huan, *The Source of Proxy in Connection with Commercial Agency in Duty*, 5 The Journal of Yunnan University Social Sciences Edition 114, 116 (2022).

by senior executives derives from the authorization of the board of directors. In other words, the management power of the company has originally been granted to the board of directors, which chooses to partially transfer the power to the senior executives due to the complexity and professionalism of modern corporate governance. Such transfer is a bilateral legal act, which should be completed through an 'appointment resolution' plus an 'employment agreement'. In addition to the resolution by the board, the company should also sign a contract with the senior executives, specifying their functions and powers, compensation, annual leave, and so on. Therefore, if the promisor holds the position of senior executive in the target company, it can only obtain the management power after being appointed as a senior executive by the board and signing the employment contract with the company.

Secondly, as to the exercise and contents of power, the promisor should abide by the Company Law, corporate documents including the AOA and resolutions, as well as the corporate governance clauses. As to the scope of the management power, there are three kinds of opinions, i.e. it is determined by law, by conduct, or falls in between.[20] This paper believes that the 'in-between' view is more reasonable by integrating the other two opinions, that is, the scope of the promisor's management power is jointly determined by law, the AOA, and agreements between the parties. To be specific, the Company Law stipulates the mandatory functions and power of the management. Without conflicting with the law, parties can grant the promisor the agreed management power through the AOA or contracts. Therefore, while exercising management power, the promisor should not only strictly follow the Company Law, the AOA, and company resolutions, but also be constrained by the corporate governance clauses. If the promisor violates the provisions concerning the scope of the power, procedures, and methods to exercise the power in the corporate governance clauses, it shall bear legal responsibilities accordingly.

Lastly, in terms of the termination and relief of power, if the promisor is deprived of the management power improperly, within the framework of the current legal system in China, it may only obtain protection under the contract law. In general, there are various situations in which the promisor's management power is terminated. This paper mainly focuses on two situations: the promisor is dismissed from his position and the promisor voluntarily resigns.

20 ZHAO WANYI, CORPORATE MANAGERS AND THEIR RIGHTS, at 103 (Law Press・China, 2013).

When the promisor is dismissed, such dismissal is effective from the perspective of the organizational law as long as it conforms to the provisions of the Company Law and the AOA. Under the current principle of arbitrary dismissal in China, there is no need to provide a reason. If provisions for breach of contract are included in the performance commitment agreement, the promisor can claim that the dismissal violates the contract and pursue the promisee's liability for breach of contract. However, the promisor has no right to ask for compulsory performance of relevant provisions and the target company to reinstate its management position. The problem is, if no clear provisions on a breach of contract are included, whether the promisor can get legal remedies. This paper argues that it depends on whether there is a justifiable cause for the dismissal to strike a balance between protecting the freedom of contract and corporate autonomy. On the one hand, if the promisor is dismissed without a proper reason, it shall be deemed an improper deprivation of power, and the promisor may claim a fundamental breach of contract and request the rescission of the contract. On the other hand, the protection of the promisor's management power should be limited to a certain degree to avoid damages to the legitimate interests of the company. With proper reasons, the promisee has the right to remove the promisor from its position without assuming the liability for breach of contract. Therefore, if the dismissal is attributed to the promisor, such as the promisor violating professional ethics, the AOA, or laws and regulations, the dismissal shall be regarded as a reasonable and necessary management decision. Under such circumstances, the promisor has no right to require the termination of its compensation obligation prescribed in the performance compensation provisions. Otherwise, it will violate the legal spirit of strictly abiding by the contract and the business ethics of bearing the consequences of one's actions, and will not be conducive to establishing a correct behavioral orientation.

If the management power is terminated due to the promisor, the promisor's compensation obligation cannot be removed. As the contractual relation between the management and the target company is to some degree personal, the promisor should be allowed to terminate the contractual relation with proper reasons. However, the termination does not mean that existing contractual obligations can be ignored; otherwise, it will provide paths for the promisor to avoid its compensation obligation and violate fundamental contractual spirits. As can be seen, when the corporate governance clauses are terminated due to the promisor's resignation, the effectiveness of the performance compensation clauses is in principle not affected.

B. Regulations for the Promisor to Exercise Its Management Power

To avoid performance compensation obligation, the promisor, who enjoys the management power, might adopt illicit means such as earnings management to achieve the short-term performance goals at the cost of the company's long-term interests. This not only harms the legitimate rights and interests of the promisee, the target company, and their stakeholders, but also damages the health and fairness of the market. Therefore, it is necessary to use legal means to regulate the acts of the promisor. For this, two paths exist: the contract law-based path, which introduces the theory of conditional contracts and specifies the legal responsibilities of the promisor, and the organizational law-based path, which stipulates the fiduciary duty of the promisor as the management of the company.

Firstly, according to the theory of conditional performance of contracts, if the promisor improperly facilitates the realization of performance targets, it is deemed that the conditions triggering the performance of compensation obligations have been met, and the promisor should make compensation accordingly. Currently, the Civil Code carries the traditional views of the civil law system, which only prescribes two types of conditional contracts: the contract whose effectiveness is subject to certain conditions and the contract with dissolving conditions which shall become invalid when such conditions are satisfied. The theory of conditional performance has not been formally adopted. But in overseas market, such theory is widely accepted, and the Anglo-American contract law refers to it as 'express conditions'.[21] This paper suggests that the theory of conditional performance of contracts should be introduced, and the failure to meet the performance targets should be defined as the performance condition of the promisor's payment obligation under the performance commitment agreement. That is, the promisor shall perform the payment obligation only when the agreed conditions occur. In this regard, the method of analogy can be adopted, referring to the provisions of articles 158 and 159 of the Civil Code. In the case where the promisor abuses the management power to achieve the performance targets, it is deemed that the performance targets have not been achieved, and the promisor shall still fulfill the obligation to compensate.

Secondly, the promisor, as the management of the target company, holds fiduciary duty toward the target company. If the promisor harms the company's

21 MELVIN A. EISENBERG, FOUNDATIONAL PRINCIPLES OF CONTRACT LAW, at 715-716 (Oxford University Press, 2018).

interests to achieve the performance targets, it violates the fiduciary duty and should bear corresponding legal responsibilities. After multiple revisions, the Company Law establishes the fiduciary duty system that applies to directors and senior executives. It provides that the contents of fiduciary duty including the ‘duty of loyalty’ and the ‘duty of diligence’ (equal to the ‘duty of care’ under the Anglo-American law), and lists three specific rules for the duty of loyalty: no self-dealing, no taking advantage of corporate opportunities, and no competing with the company.[22] In addition, the *Guidelines for Articles of Association of Listed Companies* issued by the CSRC has enriched the provisions of the fiduciary duty of directors of listed companies.[23]

The promisor violates the duty of loyalty to the target company if the performance goals are met precisely by short-termism acts or earnings management to avoid compensation obligation. The duty of loyalty includes both negative and positive obligations, by which the former requires the management to refrain from acts that will injure the interests of the company, while the latter requires the management to fulfill its duty in good faith and safeguard the company’s interests.[24] If the promisor realizes the performance targets using earnings management and avoids payment in cash or stock and personal economic loss, it violates the duty of non-profit included in the negative duty of loyalty.[25] Moreover, although the target company’s short-term performance may appear to be improved, this is detrimental to the company’s long-term development and is not in the company’s best interests. This constitutes a violation of the positive duty of loyalty. The promisor, knowing its act might cause damages to the long-term interests of the company and investors, still chooses to manipulate the performance for personal gains, thereby violating the duty of loyalty, and should bear corresponding legal liability.

IV. PROTECTION AND CONSTRAINTS OF THE SHAREHOLDER’S RIGHTS OF THE PROMISEE DURING THE PERFORMANCE COMMITMENT PERIOD

As a shareholder of the target company, the promisee enjoys corresponding economic and administrative rights at the company. Among

22 Articles 180, 181, and 182 of the *Company Law of the People’s Republic of China (2023 Revision)*.

23 Articles 97 and 98 of the *Guidelines for Articles of Association of Listed Companies (2023 Revision)*.

24 Ye Lin, *A Director’s Duty of Loyalty and Its Expansion*, 2 Political Science and Law 16, 24 (2021).

25 EVAN J. CRIDDLE, PAUL B. MILLER & ROBERT H. SITKOFF, THE OXFORD HANDBOOK OF FIDUCIARY LAW, at 384-403 (Oxford University Press, 2019).

them, the voting rights are at the core of the shareholder's administrative rights and function as a powerful 'weapon' to counter the management power of the promisor. However, as mentioned above, in the special context of performance commitments, the promisee agrees to compromise and constrain its voting rights through mutual agreement. The constraint is mainly manifested in the selection and appointment of the corporate management, that is, the corporate governance clauses directly specify the appointment of the directors and senior executives of the target company, with the promisee constraining to perform its majority voting rights. An important issue in the field of company law arises under this type of agreement as to whether the parties can constrain shareholder's rights, including the voting rights, of the promisee through a contract.

A. Contractual Constraints on the Voting Rights of the Promisee by the Performance Commitments

Based on the analysis of M&A cases in China's capital markets, this paper summarizes the constraints on the voting rights of the promisee specified in the corporate governance clauses into two categories. The first one is to constrain the scope of matters on which the shareholders may exercise their voting rights. The Company Law lists eight specific matters, including the selection and replacement of directors, that the shareholders can exercise their voting rights, and allows the AOA to expand the scope of voting functions. However, it does not specify whether the AOA can remove the matters listed by the Company Law and thereby narrow the scope of shareholders' voting functions.[26] To secure the management power of the promisor, the corporate governance clauses may prescribe that the promisee does not enjoy voting rights on specific matters such as the appointment and removal of certain directors, and those directors will be directly designated by the promisor. The second one is to constrain the direction by which the shareholders exercise their voting rights, that is, the promisee must perform its voting rights in a specific way to achieve certain results. This type of agreement is also known as 'shareholder voting agreement'.

Theoretically, the biggest issue of the above-mentioned clauses is that they clash with the intrinsic nature of shareholders' voting rights. Most scholars in China believe that the voting rights of shareholders are intrinsic,

26 *Supra* note 22, article 59.

and cannot be deprived of or constrained by private autonomy unless otherwise specified by law.[27] The reason is that authorizing the overseeing right to the residual claimant (i.e. shareholders) is the best choice in line with the agency theory and the incentive theory. Exercising the voting rights is a major way for shareholders to oversee the company. Once deprived, it will remove the deterrence and the protection of shareholders. Therefore, unless otherwise prescribed by law, the voting rights of shareholders shall not be restricted by the AOA or contract provisions. In other words, restrictions on shareholders' voting rights will only be legally effective if the conditions and procedures stipulated in the Company Law are met. According to the Company Law, there are two main situations in which shareholders' voting rights can be restricted. Firstly, by article 65, a limited liability company stipulates in its AOA that shareholders do not enjoy voting right in proportion to their capital contributions. Secondly, by article 144, a joint stock company issues class shares with differential voting rights arrangements. Apparently, the above-mentioned arrangements specified by the corporate governance clauses do not fall into these two categories. Therefore, corporate governance clauses do not have a legal effect from the perspective of the organizational law. That said, the effectiveness and enforceability of the contract law need further discussion.

This paper proposes that, in order to encourage business innovations and safeguard the order and interests of companies at the same time, we should distinguish two different questions regarding the corporate governance clauses: whether such clauses are legal and effective, and whether such clauses can be enforced. As to the restrictions on the scope or direction of shareholders' voting rights, as long as such restrictions are not intended to harm the company or violate mandatory laws and regulations, they are generally regarded as legal and effective. However, the promisor is not able to require specific performance of such clauses; otherwise, they would violate the intrinsic nature of the voting rights. In other words, shareholders have the right to appoint or dismiss the management through majority votes. Even if the decision violates the corporate governance clauses, provided that the clause does not contravene mandatory legal provisions, the effectiveness of the resolution in organizational law is not affected. Under such circumstances, the promisor can only seek protection from the contract law, requiring the promisee to take the liability of breach of contract or terminate the contract.

27 SHI TIANTAO, CORPORATION LAW, at 262-264 (Law Press · China, 2014).

B. Regulations for the Promisee to Exercise Shareholder's Rights

To get compensation, the promisee may take various measures during the commitment period to interfere with the operations of the target company. Firstly, the promisee might interfere with the appointment of the management by replacing the incumbent management with those who are not familiar with the target company or do not support the previous business strategies. Secondly, the promisee may reallocate key resources (such as human resources, capital, and techniques) to other subsidiaries or projects, so as to affect the performance of the target company. Thirdly, the promisee may hinder the company's market access in various ways, including stopping the original marketing activities, abandoning the original sales channels, etc. By such means the market share of the products or services of the target company is reduced, and the performance targets are hard to be met. Those measures would not only undermine the fulfillment of the performance targets but also negatively impact the overall operations and long-term development of the company. Hence, it is necessary to regulate the acts of the promisee by law, avoiding the abuse of shareholder's rights.

It is a tricky problem to determine whether the acts of the promisee exceed the boundaries of proper use of shareholder's rights. In the face of such disputes, Chinese courts usually discuss it from the perspective of contract interpretation, focusing on whether the acts of the promisee violate the provisions in the performance commitment agreement. If the agreement sets an assistance obligation for the promisee, and the promisee's acts do not comply with the agreement, then the promisor can assert the liability of contract breach on this ground. The problem is that, in practice, provisions on the promisee's assistance obligation are usually too general in the corporate governance clauses. So can the promisee's acts be regulated by law in the absence of definite provisions in the performance commitment agreement? This paper argues that it is necessary to set assistance obligation for the promisee, so as to strike a balance between the parties concerning their rights and obligations, as well as prevent the abuse of shareholder's rights. The nature of this obligation should be defined as a legal obligation, which can be realized through two legal paths: the accessory obligation based on the principle of good faith, and the fiduciary duty of the controlling shareholders.

From the perspective of the contract law, it should be specified that the promisee has an implied accessory obligation to assist the normal operations of the target company. *Guanzi*, an ancient Chinese political and philosophical text, states that honesty and good faith are the foundation of all principles. Good faith is not only the traditional virtue of the Chinese people but also a basic and overriding principle in civil law. The accessory obligation, derived from the principle of good faith, aims to ensure the fair performance of the contract and protect the legitimate expectation of the parties. Assistance obligation is a typical accessory obligation for contracts, that is, the party should provide reasonable support and cooperate with the other party to perform the contract, which is known as the 'implied obligation of good faith and fair dealing' in the Anglo-American legal system.[28] The promisor makes a performance commitment based on its trust in the promisee, that is, the promisee is believed to support and cooperate with the operation and management of the target company, thereby making it possible for the promisor to achieve performance goals through hard work. When the promisee hinders the achievement of the performance targets through inappropriate acts, it constitutes a violation of the implied accessory obligation.

Indeed, the implied obligation does not mean that the court can expand and revise the explicit terms in the contract arbitrarily, nor does it serve as a tool for one party to avoid liability or obtain disagreed benefits. This paper suggests that while determining whether the promisee violates the implied assistance obligation, a strict scrutiny standard shall apply. Firstly, the assistance obligation of the promisee is a negative obligation, which requires the promisee to refrain from improper interference with the running of the target company. In other words, if the promisor claims that the promisee violates the assistance obligation, it bears the burden of proof that the promisee has taken positive action to prevent the achievement of the performance targets.[29] Secondly, the promisee intentionally takes action to hinder the fulfillment of the performance targets. By doing this, the trust foundation of the contractual relationship and the legitimate expectation of the promisor are undermined. However, if the promisee's actions can be reasonably interpreted as having other reasonable business purposes, the court may hold that such actions do not constitute a breach of ancillary obligations.[30] Thirdly, there is causality between the promisee's act and the unfulfillment of the performance targets. The promisor must

28 George Blum, *Breach of Contract or Implied Covenant of Good Faith and Fair Dealing with Respect to Earnout Provision*, 34 American Law Reports 1, 2 (2017).

29 *Shi Jun et al. v. Kehua Data Co., Ltd.*, No. 59 Final Civil Judgment of Beijing High People's Court (2022).

30 *CCM Rochester, Inc. v. Federated Investors, Inc.*, 234 F. Supp. 3d 501 (S.D. N.Y. 2017).

provide concrete and direct evidence, proving that the specific act by the promisee has directly led to the failure of the performance targets. In theory, violation of accessory obligation generally only leads to liability for damages rather than termination of the contract. However, this paper argues that, considering the above-mentioned theory of contract conditions, if the promisee violates the accessory obligation, making the target company fall short of its performance targets, it should be regarded that the target company has met the performance targets and the promisor does not need to bear the compensation obligation under the relevant provisions of legal fiction on the accomplishment of conditions in the Civil Code.

From the perspective of the company law, the rules of the fiduciary duty of controlling shareholders should be improved to constrain the acts of the promisee. The Company Law includes multiple provisions concerning the fiduciary duty of controlling shareholders. For example, article 21 specifies the principle of 'no abuse of shareholder's rights'. However, it applies to all shareholders instead of the controlling shareholders, and the description of such an article is too general to be used as a judgment standard in practice. Article 22 forbids controlling shareholders to injure the interests of the company through related-party transactions, of which the scope of application is too narrow. Overall, rules relating to the fiduciary duty of controlling shareholders are not yet systemic and complete. This paper argues that the fiduciary duty of the controlling shareholders should be explicitly defined in the Company Law, with its scope appropriately expanded. As a principle, the controlling shareholders shall not use their controlling positions to harm the interests of the company under any circumstances.

If the promisee, at the cost of the interests of the target company and other shareholders, abuses its shareholder's rights and undermines the performance targets to get compensation, it constitutes a violation of the fiduciary duty. It is worth noticing that the fiduciary duty of the controlling shareholders and the management differs. As shareholders are not responsible for running the company, the primary concern of their duty is the duty of loyalty. In terms of the standards for the duty of loyalty, corporate management should always focus on maximizing the interests of the company without seeking personal gains. While for shareholders, it is natural for them to exercise shareholder's rights in their own interests. They do not violate the duty of loyalty as long as their acts do not inappropriately damage the interests of the company and other shareholders. To be specific, the duty of loyalty of the controlling shareholders includes two aspects. Firstly, while exercising shareholder's rights, the controlling shareholders should have legitimate business purposes and conduct them in good faith. Secondly, they should also avoid the conflicts of interest with the company, including not injuring the company's interests through related-party transactions, not taking advantage of the corporate opportunities, or competing with the company in business. Therefore, if the promisee's acts impair the interests of the company and are conducted without a legitimate business purpose, it constitutes a violation of the duty of loyalty and the promisee shall bear legal responsibilities accordingly. Legal consequences of violating the fiduciary duty include disgorgement of profits, constructive trust, injunction, and liability for damages.

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