

BARGAINING FOR COMPENSATION IN THE SHADOW OF REGULATORY GIVING: THE CASE OF STOCK TRADING RIGHTS REFORM IN CHINA

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I. INTRODUCTION

The split share structure¹ is a unique Chinese phenomenon that has plagued its capital markets. It arose out of classifying shares based on ownership whereby only certain types of shares were allowed to trade on the Chinese exchanges. The remaining types, constituting the majority of shares, were not allowed to trade and could only be transferred privately.²

¹ “Split share structure” is the translation of “股权分置” used in the China Securities Regulatory Commission English website, http://www.csrc.gov.cn/en/homepage/index_en.jsp (last visited Dec. 26, 2006). It is also sometimes translated to “equity division” or “share divestment” by some translators.

² China, being of civil law tradition, naturally adopts the civil law classification of companies. Unlike the common law traditions where most limited companies are limited by shares regardless of whether they are public or private companies, China only recognized two classes of companies: limited liability companies and companies limited by shares. The former is very similar to the private companies under common law while the later is akin to the public companies. The setting up and management requirements are much more onerous for the companies limited by shares. Also, only companies limited by shares can issue shares to the public and be listed on the stock exchange: *See generally*, 施天涛, 商法学 [SHI Tiantao, COMMERCIAL LAW] 143-149 (Beijing, Law Press 2004). Hence, shares in China (and other civil law jurisdictions) have a much narrower

This non-trading of the bulk of shares resulted in severe market deficiencies, such as conflicts of interest between the non-tradable shareholders³ and tradable shareholders, erosion of the capital market pricing mechanism and problems in corporate governance. While it is not the sole cause, the split share structure certainly has contributed significantly to the poor performance of the Chinese markets.

Both the need for reform and the difficulty of the legal issues involved cannot be over-stated. At first sight, the reform of the split share structure seems to be a simple lifting of the trading restrictions on non-tradable shares. However, the tradable shareholders, who usually paid artificially inflated prices because of the split share structure, would suffer a significant loss in their share prices using the simple rule of supply and demand.⁴ On the other hand, the non-tradable shareholders would receive a substantial profit from being able to sell their shares at a much higher price than under the private transfer market. The failed 2001 reform attempt that simply allowed the trading of non-tradable shares without any mention of compensation underscored the complexity of the legal issues. Learning from the series of past failed attempts, the Chinese regulatory authorities have implemented the current on-going reform utilizing a privatized bargain mechanism whereby the non-tradable shareholders negotiate with the trading right from the tradable shareholders.

This article is about China's reform. The policy nature of market reforms in China means legal analysis is usually relegated to the backseat. Nevertheless, we aim to provide a comprehensive and in-depth legal analysis of this reform. The central legal question is whether the Chinese regulatory authorities can simply grant the trading rights (and the huge benefits that such rights would bring about) to non-tradable shareholders.

meaning than in common law jurisdictions. It is important for civil law traditions that certain shares in companies limited by shares are barred from trading on the stock exchange.

³ "Non-tradable shareholders" and "non-tradable shares" is our preferred translation for "非流通股" and "非流通股". The flip side will be "tradable shareholders" and "tradable shares" for "流通股" and "流通股". This is one of the two types of translations that have appeared in the related documents posted on the China Securities Regulatory Commission English website, *id.* The other is "non-floating shareholders". Some translators also used the term "non-floatable shareholders" and "non-circulation shareholders". For informational purposes, "tradable shares," "circulation shares," "floating shares," and "floatable shares" turn up respectively 5292, 441, 492, and 29 search counts on the Yahoo China search engine, 雅虎首页 [Yahoo! Main Page], <http://www.yahoo.com.cn/> (last visited Oct. 31, 2006).

⁴ An increase in the supply of shares with the non-tradable shares entering the stock market will not match a corresponding increase in demand, especially in the short term. The demand of the shares traded on the stock exchange is primarily dependent on the number of investors and amount of investment capital, which will largely remain the same in the short-term with or without the trading of non-tradable shares.

Put another way, do the tradable shareholders have any right to compensation from either the non-tradable shareholders or the Chinese regulatory authorities when their non-tradable shares are allowed to trade? This is a legal question that not only requires the close examination of the private relationship between the non-tradable shareholders and the tradable shareholders, but it will also bring into focus the government's role in this tripartite relationship. Should the government compensate losses to private parties that arise out of its regulations and policies? Specifically, should the regulatory takings doctrine⁵ be extended to our case where the tradable shareholders suffer a direct loss from a regulation which does not directly target them? Should the non-tradable shareholders be allowed to simply enjoy the huge profits from the government regulation without any charges and at the expense of the tradable shareholders?

To answer these questions, Part II first traces the historical background of this reform and also explains how the reform is currently implemented. We then examine the traditional approaches towards the legal basis of the reform in Part III. Private law remedies are discussed first before we look into the public law remedies. Contract theory – which concludes that tradable shareholders should be compensated by non-tradable shareholders since the trading of non-tradable shares now breaches the contract term that the shares “temporarily not trade” – is the predominant theory among Chinese legal scholars. However, we refute the validity of contract theory's result by both critically examining the theory's premises and applying contractual principles. Arguably, the tradable shareholders' loss is caused by the regulatory authorities allowing the non-tradable shares to trade on the stock exchange. Hence we proceed to look into public law remedies. Chinese doctrine on protecting private property from government actions is still at its infancy and is too limited in scope to provide a plausible legal basis. As a comparative study, we apply the more developed U.S. takings doctrine to this reform, but even that fails to provide tradable shareholders with any basis or right to compensation. The difficulties in categorizing the legal basis of the Chinese reform under the traditional dichotomy of private law and public law demonstrates the blurring of the public-private distinction. The incorporation of a privatized bargaining mechanism in the essentially public nature of market reform underscores the limitations of a strict public-private dichotomy.

⁵ Regulatory *takings* doctrine refers to the US legal doctrine that requires the government to compensate individuals when they suffer property value diminution due to government regulations. See *infra* Part III.B.3.

This is where we turn to the givings doctrine in Part IV. Mirroring takings doctrine, which focuses on identifying which deprivation of property caused by the government must be compensated, givings doctrine seeks to determine under what circumstances must the beneficiaries of government actions be charged for a received benefit. Abraham Bell and Gideon Parchomovsky only recently developed the givings doctrine from the U.S. takings doctrine in the *Yale Law Journal*.⁶ We argue for its merits and relevance to the Chinese reform, including the inextricable relationship between takings and givings, their similar effects on relative wealth, risks of abuse and other political vices and fairness and efficiency considerations. We explain that the givings doctrine can provide a legal basis for regulatory authorities requiring non-tradable shareholders to compensate tradable shareholders before trading. From this practical application of this givings doctrine, we also highlight some of the conceptual and practical complications that have arisen and propose some refinements.

Building on this givings doctrine, we utilize economic analysis to evaluate the Chinese reform in Part V. First, we look into the choice of property rule over both liability rule and mandatory transfer rule when granting tradable shareholders an entitlement to compensation. Efficiency and practical considerations affirm the Chinese approach. We next discuss the private bargaining mechanism, which is a rather unique feature in the Chinese system, where centrally-administered reform is more of the norm. Though we give due credit to the Chinese reform, we also identify its limitations in Part VI. These limitations have resulted in the risks of over-compensation and holding out that could possibly undermine and even derail the reform process. We propose some recommendations that we believe will both deal with those risks and improve the efficiency of reform implementation. These recommendations are not only relevant to this China's reform but are useful in future practical application of the givings doctrine.

Indeed, the Chinese reform has proved to be a fruitful application of the givings doctrine. In the conclusion, we identify the unique nature of givings under the Chinese reform. The reliance of a property rule protection and the requirement for a private precondition not only represents novel departures from the original givings doctrine, but also further advance the efficiency and fairness merits of givings charging. Similarly, the innovative utilization of mixing entitlement protection and the extension of compensation rights to derivative takings provides invaluable practical lessons and useful pointers that are relevant to future

⁶ Abraham Bell & Gideon Parchomovsky, *Givings*, 111 *YALE L.J.* 547 (2001).

developments and applications of the givings doctrine, both within and without China.

II. HISTORICAL BACKGROUND AND REFORM

We first examine the historical background of split share structure reform. We highlight the problems and deficiencies arising out of this structure, and then proceed to explain the reform measures implemented by the Chinese government. This provides the basis for our later analysis and discussion.

A. *Historical Background*

One must go back in history to understand the complexity and uniqueness of the current split share structure reform in China. Since the first Chinese joint stock limited company was created in July 1984,⁷ shares have been classified by type. The Provisional Measures on the Issuance of Shares, issued in July 1984 by the Shanghai branch of the People's Bank of China, classified the shares into two categories: collective shares and individual shares.⁸ The collective shares were issued to the state, collectives, village enterprises and agricultural production teams. Individual shares were issued to workers, residents, community members and their families. When the Chinese stock exchanges were first set up in Shanghai and Shenzhen in December 1990,⁹ the shares were classified into state shares, legal person shares, individual shares and special shares in accordance with their ownership.¹⁰

⁷ 股权分置改革操作实务与后股权分置时代 [PRACTICAL OPERATION OF SPLIT SHARE STRUCTURE REFORM AND POST-SPLIT SHARE STRUCTURE] 8 (何如主编 [He Ru ed.], 2006) [hereinafter He].

⁸ 关于发行股票的暂行管理办法 [Provisional Measures on the Issuance of Share] (promulgated by Standing Comm. People's Cong., Shanghai Mun., Aug. 10, 1984, effective Aug. 10, 1984, repealed 1987), § 2, available at <http://www.law999.net/law/doc/d003/1984/08/10/00049183.html> (last visited Oct. 31, 2006).

⁹ Yuwa Wei, *The Development of the Securities Market and Regulation in China*, 27 LOY. L.A. INT'L & COMP. L. REV. 479, 488 (2005).

¹⁰ 深圳市股票发行与交易管理暂行办法 [Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares] (promulgated by the Standing Comm. People's Cong., Shenzhen Mun., May 15, 1991, effective June 15, 1991), § 33, translated in Chinalawinfo (Lexis) PRCLEG 591. Special shares are shares issued to foreign governments, legal persons and individuals.

With the exception of renaming special shares as foreign investor shares, this classification scheme was maintained until recently.¹¹

This categorization created different classes of shares, each having different rights. Shares were strictly forbidden from mixing with shares of other categories,¹² and their transfer methods varied in accordance with their category. Individual shares (also known as “A” shares) could only be traded in the stock exchange’s A shares market; the foreign investor shares (also known as “B” shares) could only be traded in the exchange’s B shares market.¹³ Cross-trading between the two markets was impossible. State shares and legal person shares, on the other hand, were prohibited from trading on stock exchanges.¹⁴ Consistent with the sacred nature of state-owned property in the Socialist economy as enshrined in the Chinese Constitution,¹⁵ state shares were also subject to many additional transfer restrictions.¹⁶ There were attempts at the initial development phase of the Chinese stock markets to allow the legal person shares to be traded on the stock exchanges. However, due to excessive demand, followed by hyperactive markets and consequent political concerns, these measures were abruptly halted and suspended indefinitely.¹⁷ All these factors resulted in entrenchment of the split share structure of China’s domestic stock market: on one side, non-tradable shares consisted of legal person shares and state shares; and on the other, tradable shares consisted of A shares.¹⁸

The classification of shares based on ownership is a phenomenon unique to China and is not found in other stock markets. Nevertheless, this classification must be understood in the context of China’s transition

¹¹ 股份制企业试点办法 [Trial Measures on Share-formulated Enterprises] (promulgated by the former St. Council Nat’l Development and Reform Comm., May 15, 1992, effective May 15, 1992), 1992 国务院公报 [ST. COUNCIL GAZ.] 549, § 4.

¹² He, *supra* note 7, at 9.

¹³ William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China’s Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT’L L. 477, 496 (2002).

¹⁴ *Id.*

¹⁵ 宪法 [CONSTITUTION] art. 12 (2004).

¹⁶ See, e.g., 股份有限公司国有股权管理暂行办法 [Provisional Measures for State Shares Management in Limited Stock Company] (promulgated by St. Council Econ. Reform Comm., Nov. 3, 1994, effective Nov. 3, 1994), § 29, available at <http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=chl&Gid=10591> (last visited Oct. 31, 2006) [hereinafter Provisional Measures].

¹⁷ He, *supra* note 7, at 10.

¹⁸ As mentioned earlier, B shares can only be purchased by foreign investors and hence are not part of China’s domestic stock market. In any case, B shares only make up a small part of the total equity market, comprising less than 6% of all shares since 1993 and hovering around 2% since 2001. *Id.* at 16.

from a socialist economy to today's capitalist economy. During the initial conceptualization and establishment of the Chinese stock market, the government had to confront a difficult ideological conflict between socialist and capitalist economies.¹⁹ During the early years of reform, any major deviation from the system of state ownership would prove too drastic and politically unacceptable. The "privatization" of the economy was a major concern for the Chinese government.²⁰ Thus, state and legal shares, which accounted for the majority of shares, were prohibited from trading in the stock market. This asserted state control over the listed companies so as to maintain the Socialist state-ownership system.²¹ Hence, the system was designed in accordance with what was most acceptable rather than what was most reasonable.²²

B. *Deficiencies in the Split Share Structure*

It is widely acknowledged that this classification of shares and accompanying trading prohibition on the majority of shares is a material cause of the Chinese stock market's deficiencies and corporate governance problems. This split share structure produced a separate set of supply and demand forces which led to different prices and earnings ratios for the same shares. This in turn resulted in different pricing for the same issue.²³ The inability to trade the majority of shares also caused an artificial inflation of share prices because the entire market, including non-tradable shares, was factored into the exchange prices of the tradable shares.²⁴ All else being equal, the price of the tradable shares will fall if the non-tradable shares are allowed to enter the market.²⁵ The artificialness of inflated share prices was evidenced by often absurdly high share prices, even of companies with negative net assets.²⁶ Another

¹⁹ *Id.* at 5; 黄曼行, 对国有股权不可流通性问题的探讨 [Huang Man Xing, *Discussion on the Non-trading Problem of State Shares*], 商业研究 [COM. RES.], No. 12, 2005 at 171, 173.

²⁰ He, *supra* note 7, at 5.

²¹ *Id.* at 8.

²² 罗培新, 非流通股流通方案的法律解析 [Luo Peixin, *Legal Analysis of Non-Tradable Shares Trading Proposals*] 17 (2001), <http://www.sse.org.cn/UpFiles/Attach/1691/2004/03/04/1657448125.pdf> (last visited Oct. 31, 2006).

²³ 关于上市公司股权分置改革的指导意见 [Guiding Opinions on the Split Share Structure Reform of Listed Companies] (promulgated by China Securities Regulatory Comm., May 31, 2005, effective May 31, 2005), ¶ 2, <http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=chl&Gid=59728> (last visited Oct. 31, 2006) [hereinafter *Guiding Opinions*]; Friedman, *supra* note 13, at 497.

²⁴ Huang, *supra* note 19, at 173.

²⁵ *Id.*

²⁶ *Id.*

practical consequence of the split share structure was the over-speculative nature of its stock market. This over-speculative nature of the market was reflected in the fluctuation of stock prices and the rate at which shares changed hands.²⁷ For the period of 1994 to 1999, the differences of the stock market's highest and lowest points in the United States and Singapore were 200% and 110%, respectively. In contrast, the Shanghai stock exchange experienced a difference of up to 500%. Similarly, for the period of 1995 to 2004, the average annual turnover rate in the Chinese stock market was always above 200% and peaked at over 400% in 2000.²⁸ This is much higher than the other stock markets, especially the mature markets.

The split share structure and its consequences led to three deficiencies in the Chinese capital markets.²⁹ First, the split share structure resulted in a conflict of interests between the non-tradable shareholders and the tradable shareholders.³⁰ Because tradable shareholders would always be a minority and unable to control or significantly influence the company, the main form of profit from the share investment would be the increase in share price. Such an increase is normally brought about by the company's improved performance, competitiveness and profitability.³¹ However, this increase in share prices could not be enjoyed by the non-tradable shareholders who were unable to sell their shares on the stock exchange. Rather, their main form of profit stemmed from utilizing the split share structure to obtain financing at a high premium (possible under the artificially inflated share prices described above) to rapidly increase the asset value of the company.³² The asset value of the company is an important price factor when the non-tradable shares are traded in private transfer deals. Hence, it is not surprising that under the split share structure, the non-trading majority shareholders were quite impervious to the secondary market share prices and were not particularly motivated to ensure the profitability and performance of the company.³³ On the other hand, the non-tradable shareholders had huge personal incentives to induce the company to issue

²⁷ *Id.*

²⁸ He, *supra* note 7, at 50.

²⁹ 吴晓求 ET AL., 金融与证券研究所中国资本市场研究报告 [WU XIAOQIU ET AL., FSI CHINA CAPITAL MARKET RESEARCH REPORT] 4 (for the tenth China Capital Market Forum organized by People's University Financial & Securities Institute, yet to be published officially) (2006) [hereinafter FSI REPORT].

³⁰ Guiding Opinions, *supra* note 23, ¶ 2.

³¹ FSI REPORT, *supra* note 29, at 6.

³² *Id.*

³³ *Id.*

more shares on the stock exchange. This resulted in a mad rush for listing and share issuance³⁴ that was not always in the interest of the company and the tradable shareholders. Needless to say, such conflicts of interest among shareholders of the same company are conducive neither to company management nor to the overall development of the capital market.

The second deficiency is the erosion of the capital market pricing mechanism.³⁵ As actual stock market share prices were only based on a minority of the total number of shares, the traded prices did not reflect the opinion of the other market players.³⁶ An important condition for a stock market pricing mechanism to operate effectively is the double-arbitrage mechanism of the primary and secondary markets.³⁷ The destruction of the primary market by the split share structure shielded the non-tradable shareholders from the effects of fluctuation in the secondary market share prices. This allowed them to profit from the issuance of new shares when the secondary prices were overly inflated without the corresponding primary market arbitrage risk present in mature markets.³⁸ In addition, the lack of market liquidity and overly speculative climate arising from the split share structure also hurt the resource allocation mechanism of the Chinese stock market.³⁹

The third deficiency concerns corporate governance. The split share structure impeded the development of both a scientific evaluation standard and an effective incentive mechanism.⁴⁰ With stock prices in the overly speculative market inaccurately reflecting the company's market value, the only possible means of evaluating the management performance is its current profit.⁴¹ However, the fact that current profit does not necessarily reflect future profitability and development means its use as an evaluative standard does not support of the company's long term development. This stands in contrast to the use of a company's market share value, which factors in considerations of both current and

³⁴ *Id.* at 4.

³⁵ *Id.* at 7.

³⁶ He, *supra* note 7, at 30.

³⁷ See, e.g., *id.* at 31.

³⁸ *Id.* at 32.

³⁹ *Id.* at 32-33. Due to transfer and trading restrictions between the different categories of shares, capital could not always move from low-yield investments to high-yield investments. Similarly, the over-speculative nature of the market meant that the share prices might not necessarily reflect the true value of shares.

⁴⁰ FSI REPORT, *supra* note 29, at 9; See also Guiding Opinions, *supra* note 23, ¶ 2.

⁴¹ FSI REPORT, *supra* note 29, at 9.

future profitability, as an evaluative standard in mature stock markets.⁴² The split share structure also limits available management incentives.⁴³ The average income of a high level manager in China consists of 85% basic salary, 15% short-term incentives (shares dividends) and practically zero long-term incentives (stock options). This is in sharp contrast with that of the U.S., where 32% is basic salary and 51% long-term incentive, or even Hong Kong, where 52% is basic salary and 27% long-term incentive.⁴⁴

Another corporate governance problem that arises out of the split share structure is the elimination of the risk of hostile takeovers via the stock market. The threat of management change following a hostile takeover pressures company management to work hard and ensures good corporate governance. This is because hostile takeovers are more likely to take place when share prices are low, which is usually attributed to bad governance.⁴⁵ However, the lack of liquidity of the majority of shares means hostile takeovers do not occur under split share structure conditions. As a result, the pressure on Chinese listed companies' management is less, while the chance of management slack is greater.

C. *The Implemented Reform*

These deficiencies underlie the clear need for reform. The "Provisional Measures on Raising the Social Security Funds through Sales of the State-owned Shares"⁴⁶ were introduced in 2001. The aim was to reduce state shareholding through permitting the trade of state shares on the stock exchange. Section 5 of these measures stated that companies with state shares should include those shares as 10% of the financing capital when they issue or reissue shares to public investors.

This regulation, implicitly based on the principle that tradable shares and non-tradable shares enjoy equal trading rights, was silent on any compensation to the tradable shareholders. The stock market reacted violently to its introduction, crashing from over 2200 points at the time the measures were adopted to around 1300 points when they were

⁴² *Id.*

⁴³ He, *supra* note 7, at 40.

⁴⁴ *Id.* at 41.

⁴⁵ Huang, *supra* note 19, at 172; Wei, *supra* note 9, at 485.

⁴⁶ 减持国有股筹集社会保障资金管理暂行办法 [Interim Measures of the State Council on the Management of Reducing Held State Shares and Raising Social Security Funds] (promulgated by the St. Council, June 12, 2001, effective June 12, 2001), *translated in* Chinlawinfo (Lexis) PRCLEG 1847.

abruptly suspended by the relevant authorities after only four months.⁴⁷ The failure of this reform is attributed to three reasons.⁴⁸ First, it was suspected that state shares were obtaining financing at a premium since, as mentioned above, share prices in the stock exchange were usually much higher than their listed value. Second, the reissue of shares usually came at a discount. This resulted in the cost of introducing new capital actually being lower than the cost of holding existing capital, which led to heavy selling. Third, the reduction of state shares in the portion of 10% of the financing capital was too insignificant to either alter the stranglehold of majority shareholders on a company or materially improve its corporate governance.

After the failed reform attempt in 2001, there was a temporary lull in reform activities. However, the Chinese stock market continued to perform poorly. For example, in sharp contrast with the high gross domestic product growth rate, which has steadily increased since recovering from the 2001 economic recession, financing from stock exchanges actually continuously and significantly declined from RMB 1169.77 billion to RMB 497.6 billion over the same period.⁴⁹ Similarly, the asset return rate has steadily declined since 1995 and only slightly rebounded over the past two years of economic overheating.⁵⁰ The failure of other policies as solutions inevitably forced the split share structure back to the center stage of reform.⁵¹

Reform was again attempted in May 2005. Four companies were selected to undergo trial split share structure reform,⁵² followed in June by a second trial round, which included 42 companies.⁵³ The relatively

⁴⁷ See 刘大洪 & 李华振, 制度创新的法学与经济学双视角分析 [Liu Dahong & Li Huazhen, *Research of Institutional Innovation in China's Stock Market in the Double Domains of Law and Economics*] (2005), http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=29525 (last visited Oct. 31, 2006); See also FSI REPORT, *supra* note 29, at 57.

⁴⁸ He, *supra* note 7, at 12.

⁴⁹ *Id.* at 26.

⁵⁰ *Id.* at 32.

⁵¹ *Id.* at 13.

⁵² 关于上市公司股权分置改革试点有关问题的通知 [Notice of the China Securities Regulatory Commission on Piloting the Share-trading Reform of Listed Companies] (promulgated by China Securities Regulatory Comm., Apr. 29, 2005, effective Apr. 29, 2005, repealed Sep. 4, 2005), <http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=chl&Gid=58138> (last visited Apr. 18, 2006).

⁵³ 关于做好第二批上市公司股权分置改革试点工作有关问题的通知 [Notice of the China Securities Regulatory Commission on the Ensuring the Successful Second Trial of Split Share Structure Reform of Listed Companies] (promulgated by China Securities Regulatory Comm., May 31, 2005, effective May 31, 2005, repealed Sep. 4, 2005), available at

smooth and successful completion of these trials led to the “Guidance Opinions on the Split Share Structure Reform of Listed Companies”⁵⁴ and “Administrative Measures on the Split Share Structure Reform of Listed Companies”⁵⁵ in September 2005, which officially began the full-scale implementation of the reform. The guiding principle behind this reform is “respect of the market order, promoting of the market’s stability and development; and safeguards of the investors’ legal rights, especially that of the public investors.”⁵⁶ Reform must be market-oriented with an emphasis on creating a market mechanism conducive to proactive resolution of the split share structure problem.⁵⁷

Under the implemented reform, the process for trading these non-tradable shares is essentially contractual in nature.

The non-tradable shareholders of listed companies shall seek the opinions of the relevant tradable shareholders in the ‘A’ stock exchange when drawing up the trading proposal⁵⁸ most suitable to the company’s actual circumstances. The reform proposal shall be approved by the relevant ‘A stock’ shareholders by class voting in accordance with shareholder meeting procedures.⁵⁹

This is essentially an agreement made between the different classes of shareholders. There is no fixed formula for trading consideration – any price is sufficient as long as the shareholders come to an agreement. Nevertheless, the use of consideration to balance the interests of shareholders is officially encouraged.⁶⁰ The main form of consideration is through the giving of shares by non-tradable shareholders to tradable shareholders.⁶¹ The remaining forms include cash and share

<http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=chl&Gid=58608> (last visited Oct. 31, 2006).

⁵⁴ Guiding Opinion, *supra* note 23.

⁵⁵ 上市公司股权分置改革管理办法 [Circular of China Securities Regulatory Commission on Distributing the Measures for the Administration of the Share-trading Reform of Listed Companies] (promulgated by China Securities Regulatory Comm., Sep. 4, 2005, effective Sep. 4, 2005), available at <http://law.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=chl&Gid=59870> (last visited Oct. 31, 2006) [hereinafter Administrative Measures].

⁵⁶ Guiding Opinions, *supra* note 23, ¶ 6.

⁵⁷ *Id.* ¶ 10.

⁵⁸ “Reform proposal” is the more literal translation of the statute. “Reform proposal” is the short-form of “split share structure reform of listed companies,” as stated in the Administrative Measures, *supra* note 55, § 5. However, most Chinese scholars use the term “trading proposal” since it is more precise in meaning compared to the many different types of “reform proposals.” We use “trading proposal” in place of “reform proposal” when translating the relevant statutes.

⁵⁹ Guiding Opinions, *supra* note 23, ¶ 8.

⁶⁰ *Id.* ¶ 4.

⁶¹ A common ratio is two to three non-tradable shares for ten tradable shares, but in some cases may vary from greater than ten to less than one per ten tradable shares.

options. The non-tradable shareholders may also further agree to not trade their shares for a time period above and beyond the legal limit of twelve months.⁶²

The trading proposal must be initiated by at least two-thirds of the non-tradable shareholders, though preferably all the non-tradable shareholders should agree.⁶³ If there is no unanimity among the non-tradable shareholders, those initiating the proposal shall make the necessary arrangements.⁶⁴ For example, the initiating non-tradable shareholders would pay the required consideration for the opposing non-tradable shareholders first. In turn, the opposing non-tradable shareholders can only trade their shares if they repay that amount to the initiating non-tradable shareholders.⁶⁵ The compensation package is subject to the approval of the State-Owned Assets Supervision and Administration Authority.⁶⁶ A two-thirds majority approval of both the total A shareholders and that of the tradable shareholders is required at the A shareholders meeting as well.⁶⁷

It is difficult not to notice the overshadowing of economic methods and terms over legal analysis in the whole reform process.⁶⁸ The "Guidance Opinions on the Split Share Structure Reform of Listed Companies" defines the split share structure as "a special problem in the transition of the nation's economic system,"⁶⁹ and its reform is to "institutionally arrange for the non-tradable shares to trade in the stock exchange."⁷⁰ Section 2 of the "Administrative Measures on the Split Share Structure Reform of Listed Companies" also emphasizes that the split share structure reform is to "remove the institutional difference in share transfer in the A share market." The predominance of these economic expressions exposes a lack of legal analysis right from the initiation of the reform.⁷¹ An economic scholar who was the head of the

⁶² Administrative Measures, *supra* note 55, § 27.

⁶³ *Id.* § 5.

⁶⁴ *Id.* § 25.

⁶⁵ E.g., 招商银行股份有限公司, 股权分置改革说明书(摘要)(修订稿) [CHINA MERCHANT BANK CO., SPLIT SHARE STRUCTURE REFORM EXPLANATION PROPOSAL (EDITED DRAFT)] 3 (Dec. 29, 2005), available at <http://www.cninfo.com.cn/finalpage/2005-12-30/16336561.PDF>.

⁶⁶ Administrative Measures, *supra* note 55, § 15.

⁶⁷ *Id.* § 16.

⁶⁸ See, e.g., 谈萧, 股权分置改革法律散论 [Tan Xiao, *Legal Discussion of Split Share Structure Reform*] (2005), http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=30922 (last visited Oct. 31, 2006).

⁶⁹ Guiding Opinions, *supra* note 23, ¶ 2.

⁷⁰ *Id.* ¶ 4.

⁷¹ Tan, *supra* note 68.

Chinese Securities Law amendment drafting team even went so far as to state that “the split share structure is a Chinese legacy policy problem and not a legal problem.”⁷² It must be acknowledged that with the majority of the listed companies having already undergone this reform,⁷³ it is highly unlikely that at this time there would be any drastic changes or policy reversals. Nevertheless, the importance of the legal analysis and critique of this reform is not diminished. Any legal lessons learned from this reform, be they positive or negative, will serve China and other transitional economies as they develop their legal systems and economies.

III. DOCTRINAL AND LEGAL BASIS: TRADITIONAL APPROACHES

In this part, we aim to explore the possible legal justifications behind the reform, which essentially requires the non-tradable shareholders to compensate the tradable shareholders for the right to trade non-tradable shares. We begin our legal analysis by looking at possible private law remedies. Contract theory, being the prevailing view among the Chinese legal scholars, will be discussed extensively. We conclude that non-tradable shareholders are not legally obliged under private law remedies to compensate the tradable shareholders. However, the tradable shareholders will clearly suffer considerable losses if the non-tradable shares can trade without any payment of compensation – an option entirely within the power of the Chinese regulatory authorities as evidenced by the 2001 reform attempt.⁷⁴ Thus, we proceed to discuss whether any public law remedies are available to the tradable shareholders to seek compensation from the relevant regulatory authorities.

A. *Contract Theory and Other Private Law Remedies*

Contract theory is the prevailing view among Chinese legal scholars as to the legal basis of the reform.⁷⁵ There was some initial

⁷² *Id.* n. 4.

⁷³ As of Apr. 24, 2006, 868 listed companies comprising of 78% of the total stock exchange value have undergone or are undergoing reform, 高国华, 创新: 股改攻坚的“法宝” [Gao Guohua, *Innovation: the Key Weapon in Share Reform*], 金融时报 [FIN. TIMES], Apr. 28, 2006, at 7, available at <http://www.financialnews.com.cn/zq/200604280192.htm>.

⁷⁴ See *supra* Part II.C.

⁷⁵ Tan, *supra* note 68, n.16; see also 方立, 民法通则公平原理: 非流通股股东当然应该补偿, [Fang Li, *Civil Law Equity Principle: Of Course the Non-Tradable Shareholders Should Compensate*], 第一财经日报 [NO. 1 FIN. DAILY], Aug. 11, 2005, at B5, available at

support of the use of tort theory, although it has not gained continued acceptance⁷⁶ and will be discussed only briefly. The central tenet of the contract theory argument is that since “temporarily not trade” was a term of the non-tradable shareholders in the share issue prospectus, it is a valid and binding contractual term. Hence, in accordance with section 77 of the P.R.C. Contract Law,⁷⁷ trading the non-tradable shares is a contract alteration that requires the agreement of all the contractual parties, and compensation is thus necessary to induce the tradable shareholders to agree to this alteration of the contract.⁷⁸ This theory is based on two related premises concerning the trading right of non-tradable shares. First, contrary to the provisions of the P.R.C. Company Law, the tradable shares and non-tradable shares are not equal; the fact that tradable shares can trade does not necessary imply that non-tradable shares can trade. Second, the non-tradable shares did not have the right to trade and thus compensation must be paid for loss arising from this new ability to trade. It is our view that this contract theory cannot provide a valid basis for the current reform. We refute the claim by first examining the two premises, arguing that only the first is valid. We then proceed by using ordinary contractual principles to unveil the flaws of the theory.

1. Share Equality

Before the latest amendment to the Company Law last year, section 130 stipulated that “shares shall be issued on the basis of the principle of public, fair and impartial. *Shares of the same class must have the same rights and benefits.* For share certificates issued at the same time should be equal in price and each share should have the same issue terms.”⁷⁹ Both tradable and non-tradable shares were created during the stock issuance at the formation of listed companies, and it was only

<http://dycj.yinet.com/article.jsp?oid=6077791>; 高峰对话: 上市公司股权全流通改革中的法律问题 [Colloquium: Legal Problems in the Listed Companies Full Trading Reform], in 赵旭东, 公司法评论 2005 年第 2 辑 [ZHAO XUDONG, COMMENTS ON COMPANY LAWS 2005 2ND ISSUE] 122, 151 (2005) [hereinafter *Colloquium in COMMENTS*]; 股权分置的真相 [The Truth About Split Share Structure], 128 财经 [CAIJING MAG.] 41 (2005).

⁷⁶ Tan, *supra* note 68.

⁷⁷ 合同法 [Contract Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999), translated in Chinalawinfo (Lexis) PRCLEG 1080.

⁷⁸ Tan, *supra* note 68; Luo, *supra* note 22, at 19.

⁷⁹ 公司法 [Company Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994), translated in Chinalawinfo (Lexis) PRCLEG 641 (emphasis added).

shortly after this process that the government imposed trading restrictions on non-tradable shares.⁸⁰ This has led some scholars to argue that no compensation should be payable to tradable shareholders for the trading of non-tradable shares.⁸¹ This theory clearly favored the non-tradable shareholders and has been rejected by the market, which consist mainly of tradable shareholders,⁸² as evidenced by the failure of the initial 2001 reform that was based on the premise that the tradable and non-tradable shares are equal.

Indeed, one cannot ignore the great difference between the market value of tradable shares and non-tradable shares.⁸³ This was especially so as the non-tradable shareholders have profited tremendously from the difference in rights between the two types of shares. It is clearly inequitable and without legal basis for them to insist on having equal rights now.⁸⁴ The latest Company Law amendments⁸⁵ change the former section 130 to the current section 127, which clarifies that “the issue of shares should adhere to the fair and just principle. *There should be equal rights among all shares within the same category.* The price and condition of issue of each share for the same type of shares in the same issue should be the same.”⁸⁶ This amendment expressly acknowledges the possibility of different types of shares with different rights even in the same issue, rectifying a major legal obstacle in the current reform. We agree that tradable shares and non-tradable shares are not equal shares with equal rights. Both types of shares are subject to different regulations, and non-tradable shares – especially state shares – have additional restrictions and applicable regulations. To insist otherwise would not only ignore the current practical and economic realities, but would also be contrary to legal principles.

⁸⁰ 陈怀东, 国有股放弃流通权了吗? [Chen Huaidong, *Has the Right to Trade State-Held Shares Been Given Up?*], 128 财经[CAIJING MAG.] 39 (2005).

⁸¹ See 单伟建, 我为什么投反对票? [Dan Weijian, *Why Did I Cast a Vote of Opposition?*], 139 财经[CAIJING MAG.] 23 (2005).

⁸² 张卫星, 理论清晰是解决股权分置问题的前提 [Zhang Weixing, *A Clear Theory is the Precondition for Solving the Split Share Structure Problem*], 第一财经日报 [NO. 1 FIN. DAILY], Mar. 30, 2005, at B1, available at <http://dycj.yinet.com/article.jsp?oid=4970081>.

⁸³ Tan, *supra* note 68.

⁸⁴ Luo, *supra* note 22, at 17.

⁸⁵ 公司法 [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) 2005 全国人大常委会公报 [STANDING COMM. NAT'L PEOPLE'S CONG. GAZ.] 548.

⁸⁶ *Id.* § 127 (emphasis added).

2. Trading Rights and Non-Tradable Shares

While we agree that the two types of shares are not equal, we do not think that non-tradable shares either lose their trading rights or did not have them in the first place. It is well acknowledged,⁸⁷ even among scholars advocating consideration be paid for trading,⁸⁸ that there are no laws or regulations expressly removing the non-tradable shares' trading rights. Luo Peixin argued that under the old Company Law sections 74 (now section 78), 152 (now repealed and subsumed under the Securities Law)⁸⁹ and 147 (now section 142), there was an obvious "implied rule" that the state shares and legal persons shares were temporarily not allowed to trade.⁹⁰ Tan Xiao, with reference to the same author but from a different publication,⁹¹ curiously left out the word "temporary." However, he did cite the additional Company Law sections 146 (now 141), 133 (now 130), 145 (now 140), and 149 (now 143), as well as section 27 of the "Provisional Measures for State Shares management in Limited Stock Company"⁹² to back up his claim.

However, their argument does not withstand close scrutiny of those provisions. Sections 74 and 152 differentiated "initiator" shares from the public issued shares. Section 147 prohibited transfer of the initiator shares for a period of three years after issuance of shares. Section 146 stated the effectiveness of a share transfer in the stock exchange. Sections 133 and 145 further explained the three-year prohibition on initiator shares' transfer and its implementation. Section 149 regulated share buybacks from companies. Section 27 of the "Provisional Measures for State Shares management in Limited Stock Company" imposed transfer restrictions on state shares. Quite clearly, these provisions regulate the trading rights of non-tradable shares, but do not go so far as to permanently remove those rights.

We are doubtful that an "implied rule" can infringe the basic property rights of the non-tradable shareholders. This is especially so considering that private property rights have been accorded legal

⁸⁷ 高志凯, 以“对价”之名剥夺财产 [Gao Zhikai, *Robbing Property in the Name of "Consideration"*], 139 财经 [CAIJING MAG.] 29 (2005); Chen, *supra* note 80.

⁸⁸ Tan, *supra* note 68; Luo, *supra* note 22, at 18.

⁸⁹ 证券法 [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) 2005 全国人大常委会公报 [STANDING COMM. NAT'L PEOPLE'S CONG. GAZ.] 586.

⁹⁰ Luo, *supra* note 22, at 18.

⁹¹ Tan, *supra* note 68, n.7.

⁹² Provisional Measures, *supra* note 16.

protection⁹³ in the newly amended Constitution. It is also important to consider article 12, which gives the utmost recognition and protection to public property,⁹⁴ because state shares contribute a significant portion of non-tradable shares. Similarly, the most recent Company Law amendments have reduced the previous three-year restriction on the transfer of company initiators' shares in the old section 147 to one year in the new section 142. There are also similar liberalizations to the other provisions. This shows that the so-called "implied rule," if it exists, is based on fluid provisions and is far from certain. Further, similar to express provisions, such a rule is also subject to alterations. Thus, while we agree that the trading and transfer of non-tradable shares is more restricted than tradable shares, we think that the trading right of the non-tradable shares was merely suspended and not removed by regulatory authorities. There are no inherent legal wrongs if the non-tradable shares are allowed to trade without payment of compensation.

3. Analyzing the Contract

Under contract theory analysis, Chinese scholars identified the share issue prospectus as the contract in question.⁹⁵ We agree with this analysis and that the breach of any guarantee, promise or term in the share issue prospectus is a breach of contract. The important question is whether the trading of the non-tradable shares results in a breach of that contract. A typical term in the share issue prospectus was usually expressed in two forms. One form of expression, commonly found in share prospectuses during the 2001 reform period, but not strictly limited to then, was as follows:

The state legal person shares and legal person shares in the company before this public issue of shares shall, in accordance with the nation's relevant policies and before the implementation of any new regulations on the trading of these two types of shares, temporarily not trade in the stock exchange. The relevant shareholders have made

⁹³ 宪法 [CONSTITUTION] art. 13 (2004).

⁹⁴ *Id.* art. 12.

⁹⁵ *See supra* note 75.

guarantees with the XX stock exchange to voluntarily lock in the shares.⁹⁶

A typical term in the share issue prospectuses after the 2001 reform attempt was as follows:

Trading restriction and time limit of shares held by shareholders before this issue of shares: In accordance with the nation's current laws, regulations and the "notice regarding XX company issuance of shares" by the Chinese Securities Regulatory Commission, the state-owned legal person shares and legal person shares shall temporarily not trade.⁹⁷

The former term quite clearly states that the non-trading was temporary in accordance with the policies of that time. It also acknowledged the possibility of new regulations altering the current status quos. This acknowledgement was omitted in the post-2001 share issue prospectuses. Nevertheless, the term in the post-2001 share issue prospectus still clearly states that there would be a temporary suspension of trading in accordance with current laws and regulations. The necessary implication from these two terms is that since the shares will *temporarily* not trade in accordance with current regulations, it is expected that the shares will trade when the policy changes. And one certainly cannot expect the regulations to remain static – especially in a transition economy.

Furthermore, Chinese scholars advocating the contract theory have ignored the fact that this term did not even appear in the share prospectuses prior to May 2001.⁹⁸ This runs contrary to the basis of their argument that the "temporarily not trade" term has been appearing

⁹⁶ E.g., HUANENG POWER INTERNATIONAL INC., SHARE ISSUE PROSPECTUS (Dec. 1, 2001); UFIDA SOFTWARE CO., SHARE ISSUE PROSPECTUS (May 14, 2001); DALAIN BINGSHAN RUBBER & PLASTIC CO., SHARE ISSUE PROSPECTUS (July 27, 2001).

⁹⁷ E.g., SHANGHAI JIAO DA ONLY CO., SHARE ISSUE PROSPECTUS (July 2, 2001); CHIXIA DEVELOPMENT CO., SHARE ISSUE PROSPECTUS (Mar. 23, 2002); BAO JI TITANIUM INDUSTRY CO., SHARE ISSUE PROSPECTUS (Apr. 6, 2002); SICHUAN ROAD & BRIDGE CO., SHARE ISSUE PROSPECTUS (Mar. 21, 2003).

⁹⁸ E.g., NANJING TEXTILE IMPORT & EXPORT CORP., SHARE ISSUE PROSPECTUS (Mar. 6, 2001); TIBET TIANLU COMMUNICATION CO., SHARE ISSUE PROSPECTUS (Jan. 16, 2001); ZHONGYUAN PETROLEUM CO., SHARE ISSUE PROSPECTUS (Nov. 6, 1999); HUBEI MAILYARD SHARE CO., SHARE ISSUE PROSPECTUS (Nov. 6, 1997); JILIN YATAI (GROUP) CO., SHARE ISSUE PROSPECTUS (Nov. 15, 1995).

consistently in all share issue prospectuses.⁹⁹ Even if we assume that there is some oral promise or implied term,¹⁰⁰ we still find it quite unbelievable to insist that the trading of non-tradable shares after a considerable period from the time of share issuance can be a breach of the term “temporarily not trade.” Most Chinese scholars advocating the contract theory have ignored this problem, and the few who have attempted to tackle it have simply explained that the ten-plus years of non-trading have resulted in the legal meaning of “temporary” changing to “permanent.”¹⁰¹ Again, this is not a satisfactory explanation.

Fang Li’s more sophisticated argument relies on *force majeure* altering the contract, and has been adopted as the legal basis in two recent publications.¹⁰² He argues¹⁰³ that the reform is a *force majeure* event that alters the original contract. Hence, the parties need not compensate each other under the Contract Law. However, since non-tradable shareholders have clearly profited at the expense of the tradable shareholders, they have to provide reasonable compensation to the tradable shareholders in accordance with the equity principle under section 5 of the Contract Law and section 4 of the Civil Law.¹⁰⁴ The shortcoming of this argument lies in the definition of *force majeure*. Section 117 of the Contract Law defines *force majeure* as an unforeseeable, unavoidable and insurmountable event. Mirroring our arguments above, we seriously doubt that the trading of temporarily non-tradable shares is so unforeseeable as to qualify as a *force majeure* event. This is especially so for the more recent prospectuses after the failed 2001 reform.

4. Tort and Unjust Enrichment

Some scholars perceived the high above-par issue as a tort or an unjust enrichment by the non-tradable shareholders, who must then either compensate for the tort or disgorge the unjust enrichment.¹⁰⁵ The false disclosure of information during share issuance also amounts to a tortious

⁹⁹ Fang, *supra* note 75. See also He, *supra* note 7, at 58; FSI REPORT, *supra* note 29, at 51.

¹⁰⁰ Luo, *supra* note 22, at 19; Tan, *supra* note 68.

¹⁰¹ 李振宁, 国有大企业应做出表率 [Li Zhenning, *Large State-Owned Enterprises Should Make Their Stand*], 139 财经[CAIJING MAG.] 28 (2005).

¹⁰² He, *supra* note 7; FSI Report, *supra* note 29.

¹⁰³ Fang, *supra* note 75.

¹⁰⁴ 民法通则 [General Principles of the Civil Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Apr. 12, 1986, effective Jan. 1, 1987), translated in Chinalawinfo (Lexis) PRCLEG 1165.

¹⁰⁵ Tan, *supra* note 68, at n.17.

act.¹⁰⁶ The problem with the first line of argument is that it applies only to shares issued in the initial listing. The old section 130 of the Company Law only stated that the price of the shares must be the same for the same price issuance. Thus, the profit arising out of the high above-par share in the subsequent issuance, while unfair, is perfectly legal.¹⁰⁷ Furthermore, the newly amended section 127 allows for different prices in the same issue as long as the shares are of different classes. In any case, the critical flaw in both lines of argument is that the tortious actions are irrelevant in the trading of the non-tradable shares.¹⁰⁸ Any claims for compensation should be made by those who suffered the loss against those who caused that loss. Not all tradable shareholders suffered losses and those that did may not even be the current shareholders. Similarly, the current non-tradable shareholders may not be the tortfeasors. Tying the trading of non-tradable shares with tortious liability will result in compensation by innocent parties to parties who have suffered no loss.

5. Conclusion on Private Law Remedies

We have shown the invalidity of the contract and tort theories as legal justifications for reform, but nevertheless sympathize with the sentiments behind the use of these theories by Chinese scholars. There is a common feeling of injustice with regard to non-tradable shares trading without any payment of compensation to tradable shareholders.¹⁰⁹ They think that the non-tradable shareholders, having profited earlier under the above-par share issuance, should not be allowed to profit again at the expense of tradable shareholders. This feeling of injustice is amplified by the fact that non-tradable shares were generally either owned by the state or big corporations while the tradable shareholders were usually small individual investors. However, one must keep in mind that unlike the tradable shareholders who could profit by selling when prices were high or limit their loss by selling when there was a threat of insolvency,¹¹⁰ the non-tradable shareholders were unable to capitalize on the profit arising from the increase in share prices and had to bear all of the insolvency risk.

¹⁰⁶ *Colloquium in COMMENTS*, *supra* note 75, at 136.

¹⁰⁷ Tan, *supra* note 68.

¹⁰⁸ Dan, *supra* note 81, at 25.

¹⁰⁹ E.g., 谢茂拾, 股改“对价”不能成为分吃国有资产的大餐 [Xie Maoshi, *Share Reform Consideration Must Not End Up as a Feast of State-Owned Assets*], 中国经济时报 [CHINA ECON. TIMES], Nov. 24, 2005, available at <http://www.cet.com.cn/20051124/FOCUS/200511241.htm>; *Colloquium in COMMENTS*, *supra* note 75, at 134-135; Luo, *supra* note 22, at 19.

¹¹⁰ Huang, *supra* note 19, at 172.

Thus, the difference in price between the tradable and non-tradable shares is easily explainable from the legal point of view.¹¹¹ After all, the so-called benefit from the above-par price did come at a cost to the non-tradable shareholders in the form of opportunity costs, liquidity and additional risk. In any case, emotional sentiments of justice should not overshadow legal analysis and cannot mask its deficiencies.

B. *Public Law Remedies*

Arguably, the Chinese regulatory authorities are the cause of the tradable shareholders' loss. Having shown that the private law remedies fail to provide a satisfactory legal basis for the payment of compensation, we now explore the possibility of using public law remedies against the Chinese regulatory authorities.¹¹² We first examine the scope of judicial review under Chinese administrative law and then analyze the applicable substantive law. Here, we also use the latest U.S. doctrine of regulatory takings enunciated in *Lingle v. Chevron*¹¹³ as a theoretical legal basis. However, we show that even the more developed U.S. doctrine fails to provide a satisfactory legal basis.

1. *Scope of Judicial Review*

Public law in China is still in its infancy, having only begun to develop in the 1990s. The main obstacle for seeking public law remedies is that section 12(2) of the Administrative Litigation Law¹¹⁴ expressly excludes any administrative regulations, provisions or decisions of non-specific application from legal challenges. The Supreme People's Court of the People's Republic of China also issued a legislative

¹¹¹ 郑钹, 股权分置需要正本清源 [Zheng Hong, *Split Share Structure Reform Needs a Clear Conceptual Basis*], 经济观察报 [THE ECON. OBSERVER], June 4, 2005, available at <http://www.civillaw.com.cn/weizhang/default.asp?id=22220>.

¹¹² For our purposes, we do not attempt to add to the extensive debate on the public-private distinction. We are more concerned about whether the tradable shareholders have any available legal remedies or rights for compensation. Hence, public law here simply refers to the available legal remedies against public entities.

¹¹³ 544 U.S. 528 (2005).

¹¹⁴ 行政诉讼法 [Administrative Litigation Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 4, 1989, effective Oct. 1, 1990), translated in Chinalawinfo (Lexis) PRCLEG 1204. While the SPC Gazette translates this law as the Administrative Procedure Law, we choose to translate it in this way to draw a distinction between it and the proposed Administrative Procedure Law [行政程序法].

interpretation¹¹⁵ which explains that “decisions of non-specific application” refers to the administrative regulatory documents issued by the administrative organization that are repeatedly applicable to non-specific targets. The courts are supposed to submit a written request to the National People’s Congress Standing Committee for review of any regulations that may be contrary to the Constitution or laws.¹¹⁶

There are three reasons for excluding “non-specific administrative actions” from judicial review.¹¹⁷ First, it is inappropriate to have an excessively wide scope of review at the initial stage. Second, according to the China’s political structure, it is the state authority and superior organization, and not the courts, that have the jurisdiction to review non-specific administrative actions. Third, non-specific administrative actions generally do not directly infringe on the legal rights and interests of the parties. This exclusion, especially that given by judicial interpretation, has been criticized by scholars as being inappropriate and outdated in light of the institutional basis and practical need for review.¹¹⁸

The aforementioned interpretation by the Supreme People’s Court gives rise to another difficulty: section 1 also excludes “non-mandatory administrative guidelines” from judicial review. This could be problematic for tradable shareholders as the nature of the split share structure reform is policy-based and many of the relevant “provisions” are in reality only guidelines. Scholars recognize that such non-mandatory administrative guidelines are becoming increasingly common and have very real implications on the rights and interests of parties.¹¹⁹ In our case, guidelines have resulted in the split share structure that has such an extensive impact on the non-tradable shareholders and tradable shareholders alike. A strong case can be made for the possibility and necessity of including this sort of administrative guideline under the scope of judicial review.¹²⁰

¹¹⁵ 最高人民法院, 关于执行中华人民共和国行政诉讼法若干问题的解释 [Supreme People’s Court, Interpretation of the Problems in Implementing Administrative Litigation Law] (promulgated by the Sup. People’s Ct., Nov. 24, 1999), 2000 中华人民共和国最高人民法院公报 [SUP. PEOPLE’S CT. GAZ.] 87, § 3.

¹¹⁶ 立法法 [The Law on Legislation of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 15, 2000, effective July 1, 2000), *translated in* Chinalawinfo (Lexis) PRCLEG 386.

¹¹⁷ 董茂云, 朱淑娣, 潘伟杰, & 刘志刚, 行政法学 [DONG MAOYUN, ZHU SHUDI, PAN WEIJIE & LIU ZHIGANG, THE STUDY OF ADMINISTRATIVE LAW] 403 (2005).

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 410.

¹²⁰ *Id.* at 411.

Notwithstanding the academic criticisms, this current state of the law effectively bars any challenge against both the initial split share structure and the implemented reform since they are based on non-specific guidelines and regulations.¹²¹ Similarly, if the regulatory authorities permit the trading of non-tradable shares without any payment of compensation, that will also be excluded from judicial review as long as it does not come in the form of specific orders. Nonetheless, since all the trading proposals under the current reform must be approved by the State-owned Assets Supervision and Administration Authority before they can be implemented,¹²² those approvals by themselves are specific administrative actions and can be judicially reviewed as discussed below.

The recently legislated P.R.C. Administrative Permit Law¹²³ may provide a possible avenue for public law remedies because the approval requirement under the reform is arguably an administrative permit defined in section 2.¹²⁴ Falling within the scope of this Administrative Permit Law brings about the right to bring an administrative action and the right to seek compensation if one's legal rights and interests have been infringed by the illegal implementation of an administrative permit.¹²⁵ Section 76 also expressly provides that compensation is payable for any infringement on the legal rights and interests of the relevant party. Both the setting up and implementation of the administrative permit must not be contrary to the law,¹²⁶ which in theory includes the Constitution. The uncertainties in this statute revolve around

¹²¹ 行政复议法 [Administrative Review Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 29, 1999, effective Oct. 1, 1999), 1999 全国人大常委会公报 [STANDING COMM. NAT'L PEOPLE'S CONG. GAZ.] 225, § 7, allows administrative review on the legality of certain non-specific regulations if they are the basis of a challenged specific administrative action. According to §§ 12-15, administrative review is conducted by the relevant government or superior administrative body. Notwithstanding any doubts on the independence of the Chinese judiciary, the lack of independence and effectiveness of this administrative review can only be worrisome for the split share structure reform, with reform implemented from the top. Moreover, § 7 still excludes from review non-specific regulations by State Council departments and commissions. This effectively bars challenge to the two most important regulations in the implemented reform because the Guiding Opinions, *supra* note 23, were issued by the State Council, while the Administrative Measures, *supra* note 55, were promulgated by the China Securities Regulatory Commission, an organ of the State Council.

¹²² Administrative Measures, *supra* note 55, § 15.

¹²³ 行政许可法 [Administrative Permit Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2003, effective July 1, 2004), 2003 全国人大常委会公报 [STANDING COMM. NAT'L PEOPLE'S CONG. GAZ.] 439.

¹²⁴ *Id.* § 2. "Administrative permit in this statute refers to the administrative authorities' action of permitting certain activities after examination in accordance with the law upon the application by the citizen, legal persons or other organization."

¹²⁵ Administrative Permit Law, *supra* note 123, § 7.

¹²⁶ DONG MAOYUN ET AL., *supra* note 117, at 208.

who is entitled to sue. The non-tradable shareholders, being the party that applies for the approval to implement the trading proposals, should have no difficulties challenging the approval or even the requirement for approval on grounds of illegality. Whether the tradable shareholders are entitled to sue as indirect targets of the administrative permit is more doubtful, even though they may have real grievance against a suspected under-compensating trading proposal.

In summary, the actual guidelines and regulations of both the split share structure and the implemented reform are excluded from judicial review under current Chinese law. However the non-tradable shareholders, and possibly the tradable shareholders, may challenge the approval of the trading proposal by the State-owned Assets Supervision and Administration Authority since it is a specific administrative action and administrative permit. We will now look in the applicable law under judicial review.

2. Applicable Law

The crux of the discussion of public law remedies is the protection of property rights. The tradable shareholders will suffer a considerable loss in share value if the non-tradable shares are allowed to trade without any payment of compensation. The question is whether this property right of the tradable shareholders is protected from government policies under the law.

Since the Property Rights Law has yet to be passed by the Chinese legislature, the most relevant law in question is the Constitution. The recent 2004 amended Constitution expressly recognizes and protects private property rights. Article 13 of the latest amended Constitution expressly states that the government can acquire the citizen's private property if required by public interest and with compensation. This provision only expressly provides for compensation under actual property acquisition or requisition. Currently, there is certainly no equivalent Chinese doctrine of regulatory takings. This means that tradable shareholders and non-tradable shareholders who suffer a loss from regulations and policies not amounting to property acquisition or requisition do not have a claim under the provision. Nonetheless, this private property protection provision makes it theoretically possible for a corresponding regulatory takings doctrine to develop in China. This is not a far-fetched thought since the Fifth Amendment to the U.S.

Constitution,¹²⁷ upon which the rich U.S. doctrine of regulatory takings was founded, is not particularly explicit on the matter as well.

The supremacy of the Constitution under Chinese law is enshrined in Article 5, which expressly provides that no law or administrative regulation shall contradict it and that the Constitution must be upheld by all entities, including government organizations.¹²⁸ Clearly, the law applicable to remedies under administrative law must not contradict the Constitution.¹²⁹ In practice, the Chinese Constitution is seldom directly applied, and no provision of the Constitution has yet been directly referred to and applied in administrative proceedings in the Chinese Courts.¹³⁰ While some scholars feel this situation will change as the rule of law develops,¹³¹ we acknowledge that the practical applicability of our discussion on regulatory takings later on and regulatory givings in the next part is severely limited by the current state of law in China. Nevertheless, it will still provide a useful reference as a comparative study and may provide guidance for future legal developments.

3. U.S. Regulatory Takings Doctrine

The U.S. Supreme court in *Lingle v. Chevron*¹³² clarified American law on regulatory takings. Two relatively narrow categories of regulatory actions will be generally deemed *per se* takings for Fifth Amendment purposes, (a) permanent physical invasion, however minor,¹³³ and (b) a complete deprivation of all economically beneficial uses of property.¹³⁴ Outside these two categories, the courts will adopt the approach in *Penn Central Transportation Company v. City of New York*¹³⁵ and look into several factors with "the economic impact of the regulation of the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations"¹³⁶

¹²⁷ U.S. CONST. amend. V, "nor shall private property be taken for public use, without just compensation."

¹²⁸ See also Law on Legislation, *supra* note 116, § 78.

¹²⁹ DONG MAOYUN ET AL., *supra* note 117, at 525.

¹³⁰ *Id.* at 19.

¹³¹ *Id.*

¹³² 544 U.S. 528.

¹³³ *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982).

¹³⁴ *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003 (1992).

¹³⁵ 438 U.S. 104 (1978).

¹³⁶ *Id.* at 124.

as the primary factors. Also, the degree in diminution of value and the "character of the government action"¹³⁷ – for instance whether it amounts to a physical invasion or instead merely affects property interests through "some public program adjusting the benefits and burdens of economic life to promote the common good"¹³⁸ – may be relevant in discerning whether a taking has occurred. On the other hand, the substantial advancement test of whether the government has "substantially advance legitimate state interest" as held in *Agins v. City of Tiburon*,¹³⁹ was held to be inapplicable to takings doctrine. Rather, its proper place is in the Fourteenth Amendment's due process jurisprudence.

Applying the U.S. law on regulatory takings to the Chinese scenario, we conclude that it still fails to provide a legal basis for compensation. Since the granting of trading rights to non-tradable shares neither physically invades the tradable shareholders' property nor completely deprives them of all economically beneficial use of property, the *Penn Central* multi-factors test must be satisfied. The tradable shareholders can make out a reasonable case by arguing that their distinct investment-backed expectations have been interfered with by the granting of trading rights, but the courts will also be aware that the prohibition on trading was to be "temporarily" imposed. Though the amount of diminution in value is neither insignificant nor particularly compelling for compensation, the regulatory granting of the trading rights is quite clearly a capital market reform which aims at promoting the common good.

The major obstacle, however, is that tradable shareholders are not the targets of the regulatory granting of trading rights to non-tradable shares. Tradable shareholders may find it difficult to obtain *locus standi* to bring an action. The courts will also be less likely to find in favor of the tradable shareholders since action for derivative takings¹⁴⁰ are yet to succeed in U.S. courts. There are concerns of opening the floodgates¹⁴¹ and over-restricting government power. As held in *Pennsylvania Coal Co. v. Mahon* and endorsed in *Lingle*, "government hardly could go on if to some extent values incident to property could not be diminished without paying for every such change in the general law."¹⁴² The

¹³⁷ *Id.* at 124.

¹³⁸ *Id.* at 124.

¹³⁹ 447 U.S. 255 (1980).

¹⁴⁰ Derivative takings refer to the diminution of property value indirectly caused by an actual taking or regulatory taking. See Abraham Bell & Gideon Parchomovsky, *Takings Reassessed*, 87 VA. L. REV. 277 (2001).

¹⁴¹ *Id.* at 299 & n.86.

¹⁴² 260 U.S. 393, 413 (1922); 544 U.S., at 538 (quoting *Pennsylvania Coal*).

unwillingness to extend compensation to those who suffered indirect but nevertheless substantial loss is evident in the case of *United States v. Causby*,¹⁴³ where it was held that only property owners directly under an established air route were entitled to compensation for the taking of the property while the neighboring property owners were not, even though their loss in property value was not any less significant. This rule was maintained by the Supreme Court in *Lucas*¹⁴⁴ where the anomaly created by the gross disparity of the outcome was noted.

In our Chinese scenario, the tradable shares still retain their usual rights associated with the shares such as voting and other shareholders rights. A significant and substantial part of the original share prices remains despite the fall in share prices from trading of non-tradable shares. Hence, even if China's scenario were to take place in United States, American courts would still be unlikely to find in favor of the tradable shareholders and order the government to compensate.

C. *Limitations of the Public-Private Dichotomy*

The difficulties in categorizing the legal basis of the Chinese implemented reform under the traditional private law and public law dichotomy demonstrates the blurring of the public-private distinction. This is especially so in the present context where restrictions on the trading rights of the non-tradable shares are lifted only upon a successful bargain between the non-tradable shareholders and tradable shareholders. Arguably, the relationship between the tradable shareholders and non-tradable shareholders is more akin to private law under the privatized bargaining mechanism. Both parties are bargaining with each other in their private capacities for their own private interests. Yet the fact that this mechanism is put in place by the Chinese regulatory authorities for the very public purpose of market reform highlights the inevitable public element in law that makes considering any legal regime truly private a leap of faith.¹⁴⁵ On the other hand, the Chinese reform is a market structural reform and more akin to public law from the government China's regulatory authorities' point of view.

Indeed, the apparent hybrid nature of the Chinese reform, which includes both elements of public and private law, underscores the limitations of a strict public-private dichotomy. In this respect, common

¹⁴³ 328 U.S. 256 (1946).

¹⁴⁴ 505 U.S., at 1019, n. 8.

¹⁴⁵ See Paul R. Verkuil, *Public Law Limitations on Privatization of Government Functions*, 84 N.C.L. REV. 397, 404 (2006).

law traditions have demonstrated significantly more flexibility. It is perhaps not surprising that it is a country with a common law tradition that conceptualizes the givings doctrine which, as shall be discussed in the next part, provides a legal basis for the China's reform.

IV. DOCTRINAL AND LEGAL BASIS: GIVINGS DOCTRINE

In the previous part we showed that both private and public law remedies are unable to provide a satisfactory legal basis for tradable shareholders to demand compensation once non-tradable shares can trade. We now examine the givings doctrine that has recently emerged in American scholarships. We argue for its merits and relevance in the Chinese context and also show that the Chinese split share structure implemented reform can be doctrinally supported by this givings doctrine.

A. *Importance and Relevance of Givings*

Givings are broadly defined as the bestowal of any benefits by the government. It can be in the form of physical (directly bestowing benefits), regulatory (where government regulation on certain property enhances the value of that property) or derivative (where a government taking or giving enhances the value of surrounding properties).¹⁴⁶ Mirroring the takings doctrine, which focuses on identifying those diminutions of property caused by the government action that must be compensated, givings doctrine seeks to determine under what circumstances beneficiaries of government actions must be charged for received benefits. As compared to the extensive and in-depth literature on takings doctrine, givings has only recently been given the attention it deserves. It was not until December 2001 that the first attempt to present a coherent theory was attempted by Abraham Bell and Gideon Parchomovsky.¹⁴⁷ Yet this lack of scholarly attention does not diminish the importance of the doctrine.

First, there is an inextricable relationship between takings and givings.¹⁴⁸ This is not only relevant in the context of developing a coherent takings doctrine¹⁴⁹ but also in the practical world where government givings or takings are likely to be accompanied by some

¹⁴⁶ Bell & Parchomovsky, *Givings*, *supra* note 6, at 563.

¹⁴⁷ Bell & Parchomovsky, *Givings*, *supra* note 6.

¹⁴⁸ *Id.* at 552.

¹⁴⁹ *Id.*

other corresponding takings or givings.¹⁵⁰ In our Chinese scenario, the regulatory giving of trading rights to non-tradable shares will result in tradable shareholders suffering a loss in the value of their shares with the regulation derivatively taking away their property. Givings doctrine is also an integral part in the protection of private property rights. The accurate assessment of fair compensation necessitates the consideration of any benefits simultaneously conferred on the taking victim.

Second, both givings and takings affect relative wealth.¹⁵¹ Current takings doctrine is only concerned with diminutions of absolute wealth. However, changes in relative wealth should not be any less important than changes in absolute wealth. Both affect the poverty gap, which should be an important social and economical consideration in any government action. In our Chinese scenario, not only will the tradable shareholders suffer a direct personal loss from the trading of non-tradable shares, the rest of society will also become relatively poorer *vis-a-vis* non-tradable shareholders who profit from this regulation. There is no justification to exclude these effects on relative wealth, especially in light of China's rapidly widening poverty gap.¹⁵²

Third, the risk of abuse and other political vices such as corruption and favoritism from unfettered takings applies equally, if not more, to unfettered givings.¹⁵³ This is because "givings may produce winners without identifiable losers, making it an attractive policy tool."¹⁵⁴ The cost of the government bestowing benefits is borne either directly (by taxes or the loss of state-owned property or public goods, which in theory belong to the people) or indirectly (through opportunity costs or relative losses) by the people. However, since the cost is often spread among a much larger group compared to the benefit's recipients, the low level of incentive of those non-recipients to oppose the giving is likely to result in inaction.¹⁵⁵ Unlike the violent reactions from Chinese farmers in response to inadequate compensation when the government acquired their land,¹⁵⁶ many forms of government givings go relatively unnoticed and,

¹⁵⁰ *Id.* at 565.

¹⁵¹ *Id.* at 552.

¹⁵² The urban-to rural income ratio widened from an already high level of 2.20 in 1990 to 3.1 in 2002. Similarly, the Gini coefficient rose from 0.35 in 1990 to 0.447 in 2001. UN COUNTRY TEAM CHINA, COMMON COUNTRY ASSESSMENT 2004, 4, available at <http://www.undp.org.cn/downloads/keydocs/cca2004.pdf>.

¹⁵³ Bell & Parchomovsky, *Givings*, *supra* note 6, at 574.

¹⁵⁴ *Id.* at 575.

¹⁵⁵ *Id.*

¹⁵⁶ The "Dingzhou incident" in July 2005 involved a massive peasant riot involving up to 250 participants. Their grievance arose from inadequate compensation for acquisition of their land, 朱

more often than not, unopposed in China. For example, the establishment of a special economic zone will provide great financial benefits in the forms of favorable tax policies and government investments in the area.¹⁵⁷ There are no takings of private property involved, although the remaining provinces and areas become relatively poorer, evident by the huge poverty gap in China. The granting of a monopoly trade license is also a common form of a givings in China that provides enormous benefits to the recipients without any real social scrutiny and objection. Nonetheless, such givings are a dangerous breeding ground for corruption and abuse.¹⁵⁸

These risks are further exacerbated in the Chinese social and political context. The lack of political accountability through popular election means the government is even more susceptible to bribes and inducement by a small number of powerful elite. The people who are discontent with the government's givings policy may not act upon their anger because of insufficient personal incentives to oppose it. Nevertheless in a democratic environment with regular elections, they may still affect the policy by casting a disapproving vote. It is easy to envision a much greater risk of abuse and corruption through government's givings in the absence of even such limited checks. In fact, it possible that had the reform policy not so directly resulted in a loss to the tradable shareholders, the stock market consisting of these tradable shareholders would not have reacted so violently when the attempted reform was introduced in 2001.¹⁵⁹ Without this reaction, the government would have been much more likely to proceed with the conferral of an enormous regulatory givings to the non-tradable shareholders without requiring their payment of any compensation or charge. Yet this type of situation remains the exception, and most givings in China remain unnoticed, unopposed and unchecked.

述古, 定州事件的反省不能止于停止征地 [Zhu Shugu, *The Examination of the Dingzhou Incident Cannot Simply Stop at Ceasing Acquisition*] 大河报[GREAT RIVER GAZETTE], July 22, 2005, at A04, available at <http://epaper.hnby.com.cn/dhb/200507/22/A04-13a.pdf>; January 2006 saw another mass protest in the Guangdong city of Zhongshan over inadequate compensation for land acquisition, 中山征地纠纷官民谈判 [Negotiation Between Government and People in Dispute over Zhongshan Land Acquisition], 大公报 [TAKUNGPAO], Jan. 14, 2006, available at <http://www.chinaelections.org/NewsInfo.asp?NewsID=44633>.

¹⁵⁷ See, e.g., 唐任伍 & 雷晓宁, 加入 WTO: 经济特区使命终结 [Tang Renwu & Lei Xiaoning, *Entry to WTO: the End of the Economic Special Zone's Mission*], 改革[REFORM] (2002), available at <http://www.reform.net.cn/article/view.php?art=502> (registration required).

¹⁵⁸ 王新亚, 薛凯, 孙金霞, 贺大为, 遏制不合理贫富差距 [Wang Xinya, Xue Kai, Sun Jinxia, He Dawei, *Halting the Unreasonable Poverty Gap*], 半月谈内部版 [CHINA COMMENT], March 2005, available at http://news3.xinhuanet.com/banyt/2005-02/28/content_2628264.htm.

¹⁵⁹ See *supra* Part II.C.

Fourth, givings, like takings, raise great concerns of fairness and efficiency.¹⁶⁰ Unaccounted givings result in positive externalities that would, if not internalized, create fiscal illusion.¹⁶¹ Regardless of which theory one might adopt as to how the government is assumed to act, this fiscal illusion will distort its incentives and is likely to lead to inefficiency.¹⁶² Unaccounted givings may cause the failure of the government to undertake economically efficient projects and distort the investment decisions of individuals.¹⁶³ Similarly, “it is inequitable to bestow a benefit upon some people that, in all fairness and justice, should be given to the public as a whole.”¹⁶⁴ Fairness may be a highly subjective term, but it is generally agreed that it is unfair for the government to discriminatorily allocate benefits on the basis of the recipient’s ability to exploit the political system.¹⁶⁵ The wealth distribution potential of givings is particularly relevant in China’s rapidly increasing poverty gap. While the policy of “let some get rich first” has its merits and may even have been necessary in the initial years of economic development and transition,¹⁶⁶ it is highly questionable whether continued givings benefiting a small group of the population still accords with fairness and efficiency. One of the contributing factors to the increasing poverty gap is the granting of monopoly trade licenses.¹⁶⁷ Allowing these licensees to enjoy great profit without any fair charge for their license promotes neither social justice nor efficiency. The demoralization effect¹⁶⁸ on those who are not recipients of government givings will also only be greater under the seemingly unassailable poverty gap.

Givings is not only an important and relevant concept in the U.S. takings doctrine, it is also highly useful and applicable in the Chinese context. If there are takings that require government compensation, there is every reason to impose charges on some government givings. We now proceed to discuss how to identify and charge these givings.

¹⁶⁰ Bell & Parchomovsky, *Givings*, *supra* note 6, at 553.

¹⁶¹ *Id.* at 554.

¹⁶² *Id.* at 581.

¹⁶³ *Id.* at 584.

¹⁶⁴ *Id.* at 554.

¹⁶⁵ *Id.* at 578.

¹⁶⁶ See Tang & Lei, *supra* note 157; 中国贫富差距已超合理限度 [*Poverty Gap in China Exceeds Reasonable Limit*], 南方日报 [NANFANG DAILY], Aug. 11, 2006, available at <http://www.nanfangdaily.com.cn/southnews/djjz/yw/200508110606.asp>.

¹⁶⁷ Wang et al., *Halting the Unreasonable Poverty Gap*, *supra* note 158; *Poverty Gap in China Exceeds Reasonable Limit*, *supra* note 166.

¹⁶⁸ Bell & Parchomovsky, *Givings*, *supra* note 6, at 579.

B. Identifying and Charging the Givings

Under Bell & Parchomovsky's classifications, the Chinese split share structure reform falls squarely into the category of regulatory givings resulting in derivative takings.¹⁶⁹ Since not every taking by the government must be compensated, not every giving should be charged.¹⁷⁰ Bell & Parchomovsky propose four criteria for identifying whether a chargeable giving has occurred, and, if one is found, what the appropriate form of charge collection should be: (a) the reversibility of the act, (b) the identifiability of the recipients, (c) the proximity of the act to a taking, and (d) the refusability of the benefit. The first two criteria are relevant in determining whether a charge should be imposed on the benefit's recipients; the latter two are relevant in determining the means of imposing the charges. We apply these criteria to the Chinese split share structure reform measures of requiring non-tradable shareholders to bargain with and pay compensation to tradable shareholders in order to trade, showing that the reform measures are supported by the givings doctrine. In the process of applying the criteria to this China's situation, we highlight the potential practical and conceptual difficulties in its initial application and propose some refinements to the criteria.

1. Reversibility of the Act

Under the reversibility of the act criterion, bestowing a benefit is more likely to be considered a chargeable giving when it could be characterized as a taking if reversed.¹⁷¹ For example, since a direct taking in the form of a penalty is naturally not compensable, a direct giving in the form of a prize is also not chargeable.¹⁷² Similarly, just as the government can redistribute wealth through imposing a tax, the large scale and non-target-specified conferment of benefits for redistribution, such as welfare programs, should also not be classified as chargeable givings.¹⁷³ Thus, for our Chinese split share structure scenario, the relevant question is whether the government needs to compensate shareholders if it removes the trading right of their shares.¹⁷⁴

¹⁶⁹ *Id.* at 571.

¹⁷⁰ *Id.* at 590.

¹⁷¹ *Id.* at 591.

¹⁷² *Id.*

¹⁷³ *Id.* at 592.

¹⁷⁴ Under §§ 55-56 of the Securities Law, *supra* note 89, the respective stock exchanges have the power to suspend or terminate the trading of shares under certain stipulated situations, such as if the company no longer satisfies listing requirements because it continuously suffered losses for three

One potential difficulty in applying this criterion is the ambiguity between compensable takings and non-compensable deprivations of property, even in the more well-developed U.S. doctrine. This means that the line between non-chargeable subsidies and chargeable givings is likely unclear as well.¹⁷⁵ However, the greater obstacle in its application to our Chinese scenario is that the regulatory takings doctrine has yet to be developed. Thus, since all regulatory takings do not currently require compensation in strict legal terms, any regulatory givings is non-chargeable according to the criterion. This is not a problem unique to China; many other countries, particularly developing countries, have yet to extend private property rights protection to regulatory takings.

We do not think that the application of this criterion should be restricted to the legal context. We think the policy aspect should also be considered, that is, if as a policy the reversed act will be considered a compensable taking, then it should as a policy be considered a chargeable giving as well. The reasons for this extension are as follows. First, the rule of law is not well established in many transitional economies, including China, and the usual mode of governance is through policy. The original cause of the Chinese split share structure scenario is itself essentially a government policy which has paid scant regard to legal considerations.¹⁷⁶ Allowing the policy aspect in the application of the criterion will allow it to play a wider and more useful role under the fledging rule of law in transitional economies.

Second, all three types of givings and takings must be taken into account to ensure the successful and accurate assessment of charges and compensations. The government is better equipped than the courts are to undertake the task of evaluating the various economical, environmental and social impacts necessary to accurately assess the effects of the relevant regulations. This is especially true in China, where its fledging legal system suffers from structural deficiencies, including a lack of professional competency among its legal officials.¹⁷⁷ Similarly, the U.S. regulatory takings and givings doctrine involves a significant amount of economic analysis that may not appeal legal traditionalists, and there are

years. The suspension under these sections is more of a penalty nature. This is not really relevant for our purpose of identifying whether the Chinese scenario is a chargeable giving since the lifting of trading restrictions is not of a reward nature. Hence, the suspension here refers to the non-penalizing suspension not covered in this statute.

¹⁷⁵ Bell & Parchomovsky, *Givings*, *supra* note 6, at 591.

¹⁷⁶ See *supra* Part II.C.

¹⁷⁷ 方立新, 司法改革的动因及其制度设计 [Fang Lixin, *Reasons and Structure for Judicial Reform*], 浙江大学学报 [ZHEJIANG UNIVERSITY JOURNAL], available at <http://www.chinalegaltheory.com/detail.asp?r=3&id=2147>.

many such traditionalists, especially outside of the U.S. The government, on the other hand, is more willing and capable of taking advantage of this principle, which can significantly improve governance efficiency and fairness.

More importantly, the central theme behind this extension and the original criterion is the need for consistent treatment. Inconsistent policies and laws are not only likely to be perceived as unfair, but may also undermine effectiveness.¹⁷⁸ Admittedly, policies are within the discretionary power of the government and hence more fluid in nature and harder to define than laws. The line between chargeable giving policies and non-chargeable benefit policies is even fuzzier than that of strict legal terms. However, policies of the Chinese government often have a more extensive impact on both society and the economy than laws. Consistency in policy implementations is no less important than that in laws.

Applying this refined criterion to the Chinese scenario, the question now is whether the government would pay compensation to the shareholders, either because of legal requirements or as dictated by policy, if it were to suspend the trading rights of their shares. The answer is likely in the affirmative. As a matter of policy consideration, suspending the trading rights without any compensation would be too drastic a step affecting the overall capital market. It would also likely be politically unacceptable, and would certainly hinder the long-term development of China's capital markets. Thus, the giving of the trading right to the non-tradable shares should be charged.

2. Identifiability of the Recipients

The second criterion involves assessing how easily identifiable the recipients of givings are. The more readily identifiable the recipients of benefits are as a group from the public at large, the more likely there is a chargeable giving.¹⁷⁹ Considerations of fairness and minoritarian rent-

¹⁷⁸ For example, if the government set the improvement of racial harmony as a policy goal, simply imposing punishments against those who disrupt racial harmony without giving due recognition to those who promote racial harmony is not likely to be a particularly effective policy implementation method. Similarly, a classic example for the importance of consistency in laws is that of the legal safeguard of human life. On one hand, it is a severe offence to kill another human life. On the other hand, if one is trying to save life, one can even go as far as killing another under the doctrine of self defense. It is inconsistent with the aim of safeguarding human life if one only punishes those who kill without making allowances for those who save life (exemption of legal liability in the form of legal defenses like self defense and necessity). Such inconsistent laws will certainly be less effective in protecting human life as well.

¹⁷⁹ Bell & Parchomovsky, *Givings*, *supra* note 6, at 593.

seeking have been identified as reasons supporting this criterion.¹⁸⁰ Singling out a small and discrete group of people for benefits or detriments when those benefits or detriments should be accepted by the public clearly offends requirements of fairness. Similarly, the more unequal the distribution of a benefit is, the greater is the risk of minoritarian rent-seeking. This criterion is also mandated by the practical considerations of implementing a charge. One cannot assess a charge if one cannot identify the targets to be charged. Transaction costs also come into play as the less identifiable the recipients of benefits are, the higher the transaction costs of identifying them for the purpose of charging. This may reduce or even nullify the efficiency and financial benefits of charging the givings.

In our Chinese scenario, the non-tradable shareholders are clearly the beneficiaries of any regulatory lifting of trading restrictions. As discussed in Part II, tradable shares are often traded at a price significantly higher than their actual value. Notwithstanding the drop in overall share value when the non-tradable shares are allowed to trade,¹⁸¹ the holders of non-tradable shares are still very likely to sell their shares at a higher price than would otherwise be possible outside the stock exchange. The non-tradable shareholders form a readily identifiable group that directly benefits from the regulation. The transaction costs of identifying them are minimal, since identification only involves a simple check into the listed companies' registry.

Hence, together with satisfaction of the first criterion, a charge should be assessed on the non-tradable shareholders for the benefits they receive from the regulatory lifting of trading restrictions.

3. Proximity of the Act to a Taking

The proximity of the giving to a taking is relevant in deciding when and how to assess the charges for the giving.¹⁸² To fully capture the benefits of efficiency and fairness, and for the prevention of political abuse discussed earlier, it is important to assess the charge accurately to reflect the actual benefits obtained. Such an assessment would necessarily take into account any takings simultaneously incurred by the benefit recipients,¹⁸³ that is, the charge imposed for the benefit must be appropriately reduced by the loss arising out of the simultaneous takings.

¹⁸⁰ *Id.* at 596.

¹⁸¹ See *supra* Part II.B.

¹⁸² Bell & Parchomovsky, *Givings*, *supra* note 6, at 596.

¹⁸³ *Id.* at 599.

We think that it should also take into account any closely connected uncompensated givings or takings in the past. Bell & Parchomovsky elected the status quo ante as the relevant baseline for measuring givings and takings, since this is the conventionally accepted baseline employed in the courts.¹⁸⁴ However, the Chinese split share structure scenario underscores the fact that the benefits of a regulatory giving are often built on a previous uncompensated taking. The trading restrictions imposed on the non-tradable shares in the early nineties can be construed as a regulatory taking of the non-tradable shares' trading rights. As a result, the non-tradable shareholders were unable to capitalize on the profit arising from the increase in share prices, and simultaneously had to bear all the risk of insolvency. This is unlike the tradable shareholders who could profit by selling when prices are high or limit loss by selling when a threat of insolvency arises.¹⁸⁵ Similarly, a large part of the benefits from up-zoning may have arisen out of a lower property value reduced by a previous down-zoning.

Fairness and efficiency considerations equally apply to historical takings and givings. Bell & Parchomovsky recognized in the discussion of the first criterion that benefiting discrete minority groups to compensate them for past wrongs should not be considered as a benefit conferment, but rather compensation, in essence taking into account past uncompensated takings. We recognize that it is impractical to take into account all past takings and givings – past takings and givings are harder to evaluate and determine – but our requirement of being “closely connected” ensures the practicality of implementation. Thus, we think that the assessment of any charge on the non-tradable shareholders should properly include the loss suffered from the initial taking of trading rights. We believe this refinement of the criterion will help improve the fairness and efficiency of charging givings.

In some cases, the taking or giving may be so intimately linked that it is both a requirement of efficiency principles and a demand of corrective justice that the compensation or charge should be made directly between the parties.¹⁸⁶ For practical purposes, the number of giving beneficiaries or taking victims must be sufficiently small and readily identifiable as a group, and the giving or taking must also be sufficiently measurable.¹⁸⁷ Under such circumstances, the direct assessment of charge and compensation between the two parties will not only reduce

¹⁸⁴ *Id.* at 613.

¹⁸⁵ Huang, *supra* note 19, at 172.

¹⁸⁶ Bell & Parchomovsky, *Givings*, *supra* note 6, at 601.

¹⁸⁷ *Id.*

transaction costs by doing away with the largely unnecessary intermediary role of the government, but will also ensure those who suffered losses are compensated by those who caused them.¹⁸⁸ In our Chinese scenario, a regulatory giving to the non-tradable shareholders and the consequential taking from the tradable shareholders are inextricably linked. Both parties are also sufficiently and readily identifiable as a group while the giving or taking is sufficiently measurable by the changes in share value. Hence, by requiring the non-tradable shareholders to bargain for the trading right from the tradable shareholders, China's reform fits this criterion. Nonetheless, as discussed in Part VI, government intervention into the private assessment between the two parties is still necessary to ensure efficiency and to reduce risks of over- and under-compensation.

4. Refusability of the Benefits

It is a straightforward and commonly accepted principle of law that one should not be forced to accept benefits against their will.¹⁸⁹ Thus, the recipients of givings have to accept the benefits voluntarily to be charged for them; if the givings cannot be refused, there should be no charge until the realization of the benefit.¹⁹⁰ The Chinese reform measures fit this criterion as well. The non-tradable shareholders need to bargain with tradable shareholders and pay the necessary compensation only if they want to enjoy the previously prohibited right to trade. Otherwise, the status quo is maintained as non-tradable shares remain not tradable.

In summary, we have shown that a charge should be imposed on the non-tradable shareholders for the granting of trading rights. Our Chinese split share scenario satisfies the first and second criteria. In addition, the close proximity of regulatory giving and derivatives taking shows the Chinese regulatory authorities are correct by requiring the non-tradable shareholders as benefit recipients to directly pay the tradable shareholders, who are the derivative takings victims. The non-tradable shareholders are also only charged for the trading right when they choose to accept it, satisfying the fourth criterion. Unlikely as it may seem, the givings doctrine born only recently on the other side of the Pacific Ocean provides doctrinal support for the Chinese reform.

¹⁸⁸ *Id.* at 600.

¹⁸⁹ *Id.* at 601.

¹⁹⁰ *Id.* at 603.

V. ECONOMIC ANALYSIS OF THE CHINESE REFORM

We have shown that by virtue of the givings doctrine it is legally sound for the non-tradable shareholders to directly compensate the tradable shareholders for being able to trade non-tradable shares. We now proceed to evaluate the implemented reform measures using economic analysis. Two features of the implemented reform stand out and merit discussion. First, the tradable shareholders are given a right under the property rule as opposed to a liability rule. Second, the reform process is privatized as opposed to being administered by the state. We analyze the merits and limitations of these choices made under the implemented reform against their alternatives.

A. *Property Rule vs. Liability Rule vs. Mandatory Transfer Rule*

The property rule-liability rule dichotomy, first articulated by Guido Calabresi and A. Douglas Melamed¹⁹¹ provides a useful tool of economic analysis. Under the property rule, an entitlement can only be removed from its holder in a voluntary transfer. On the other hand, an entitlement protected by the liability rule may be removed by simply paying an objectively determined value for it.¹⁹² The difference between these two rules has often been conceived as the difference between “protecting by deterrence” and “protecting by compensation.”¹⁹³ Madeline Morris clarified that these rules actually constitute different forms of entitlement rather than different ways of protecting one general kind of entitlement.¹⁹⁴ She further proposed a “four entitlement components” model of in-kind enjoyment, initiation choice, veto power, and monetary compensation, which she used to analyze the different possible forms of entitlement.¹⁹⁵ One form of entitlement that is relevant to our discussion is the mandatory transfer rule. Under this rule, the parties must effectuate a compensated transfer regardless of their intention and preference.¹⁹⁶ The choice of rule should naturally take into

¹⁹¹ Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

¹⁹² *Id.* at 1092.

¹⁹³ Ian Ayres & Paul M. Goldbart, *Correlated Values in the Theory of Property and Liability Rules*, 32 J. LEGAL STUD. 121, 121 (2003).

¹⁹⁴ Madeline Morris, *The Structure of Entitlements*, 78 CORNELL L. REV. 822, 844 (1993).

¹⁹⁵ *Id.* at 839.

¹⁹⁶ *Id.* at 859.

consideration the two main factors of economic efficiency and equity. For the economic analysis purposes of this piece it is not necessary to decide whether the property rule, liability rule and mandatory transfer rule are merely different ways of entitlement protections or actually different entitlements. We are more concerned with the practical merits and limitations of these rules in implementing reform. Hence, we merely focus on the efficiency and wealth distribution effect of the rules.

The economic efficiency factor is essentially an inquiry into transaction costs. Transaction costs consist of information costs, bargaining costs, and enforcement costs.¹⁹⁷ Though optimum economic efficiency will be attained regardless of the type of property protection in a world of zero transaction costs,¹⁹⁸ since the real world is far from this Coasian world,¹⁹⁹ the protection of entitlement should be designed to minimize transaction costs. The liability rule is useful in cases where the transaction costs – in particular bargaining costs – between the parties are high. The liability rule has the advantage of allowing the state to harness the information costs of the parties,²⁰⁰ and can also be designed to provide incentives for efficient takings²⁰¹ that might not otherwise take place due to high transaction costs.

According to Morris, the mandatory transfer rule will foster efficiency under two sets of conditions.²⁰² The first is if it is clear in advance that it is efficient for a particular party to enjoy a certain right while distributive considerations favor compensating the other party. The second is if it is not sufficiently clear that an efficiently-compensated transfer will occur with either the property or the liability rule. The transfer may not occur if the efficiency of transfer arises out of benefits to a third party.²⁰³ Morris does not think the parties should be forced to spend their money for the benefit of a third party, save in circumstances where the party owes a duty to the third party.²⁰⁴ However, we do not see why the presence of positive externalities and greater overall wealth maximization should not be a factor favoring the mandatory transfer rule

¹⁹⁷ Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 148 (1979).

¹⁹⁸ Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 19 (1960).

¹⁹⁹ Academics later named the hypothetical world of zero transaction cost after Ronald Coase.

²⁰⁰ Ayres & Goldbart, *supra* note 193, at 122.

²⁰¹ *Id.* at 123.

²⁰² Morris, *supra* note 194, at 861.

²⁰³ *Id.* at 862.

²⁰⁴ *Id.* In justifying the use of the mandatory transfer rule, Morris focused on situations where the duty owed to third parties is difficult to detect or prove, and where the infrequent violations of the duty are extraordinarily important. She did not include the presence of third party benefits (and hence possibly greater overall wealth maximization) or positive externalities as factors.

over the property or the liability rule. It is economically efficient and maybe even equitable to mandate a transfer that will bring about significant overall social benefits, but would otherwise not take place under either a property or liability rule. Universal conscription in small vulnerable countries is one example where mandated transfer will accord efficiency. Under universal conscription, all citizens (usually all males) must "transfer" their time and effort in the form of military service in exchange for some monetary compensation, regardless of their or the government's desire.²⁰⁵ The property rule (i.e. voluntary military service) would be too costly, while the liability rule (i.e. the government can decide whether or not to enlist a certain citizen) is likely to lead to abuse and feelings of discrimination by those who are actually enlisted.

The Chinese reform employs the property rule. The trading of non-tradable shares requires approval by the tradable shareholders, who possess a veto power. As compared to the liability rule where the tradable shareholders can trade their shares by simply paying a court or regulatory authority a pre-determined compensation, fewer transaction costs in the form of administrative costs are incurred under the current reform. This is the benefit from the absence of administrative or judicial intermediaries. In addition, the assessment of compensation involves a great deal of intimate and specific knowledge of each company, which may place an excessive burden on the administrative or judicial intermediaries.

This property rule protection also helps to level the playing field between the tradable and non-tradable shareholders. Unlike the non-tradable shares, which are usually held by a very small group, the tradable shareholders are a diverse group of small-scale individual investors. Their ability to bring about an action to seek compensation under the liability rule is severely limited. There is also the usual concern of free-riders. Thus the liability rule is likely to lead to enforcement problems and injustice against those tradable shareholders not well placed to challenge any inadequate compensation. Taken together, the additional administrative costs from the judicial or administrative intermediaries under the liability rule appears to outweigh the bargaining costs between the parties under the property rule, making the property rule more economically efficient than the liability rule.

²⁰⁵ The systems of national service in Singapore and Taiwan offer examples. The government must accept the national service of the citizen, regardless of whether it is actually in the national interest. This is particularly tricky when it comes to certain ethnic or religious groups, which may prove more a threat than assistance to national defense. Nonetheless, the government must still find places to accommodate such citizens, usually in some less sensitive and unimportant position, even though it might be cheaper and less troublesome to simply not enlist that citizen.

Nonetheless, the property rule inevitably comes with the risk of holdouts, which will be discussed in greater detail in the next part. Suffice it to say now that this risk is a significant one and has the capacity to derail the reform process if not adequately addressed. Here, the mandatory transfer rule may prove useful because the two conditions for efficiency discussed above are satisfied in our Chinese scenario. First, enjoyment of trading rights by the non-tradable shareholders is an efficient allocation, though the tradable shareholders should be properly compensated by virtue of givings doctrine. The non-trading of certain shares under the split share structure is the root of many market structural deficiencies. On the individual level, the non-trading of shares results in both significant opportunity costs and poor corporate governance, and in fact, the whole purpose of the reform is to correct these developmental abnormalities. Second, there is no guarantee that the non-tradable shareholders will trade, even under the liability rule. For example, the non-tradable shareholders in a particular listed company may be so diverse that their various conflicting personal interests will prevent an agreement on trading. They are also unlikely to be too concerned about the benefits to the company in terms of better corporate governance and to the Chinese stock market through reforming current structural deficiencies, especially when immediate personal interests are at stake.

Hence, imposing a mandatory transfer rule that requires all non-tradable shareholders to gain the trading right of their shares by paying an amount determined by the courts or administrative authorities may ensure that the implementation of reform for the greater good is efficient and effective. Of course, a mandatory transfer rule is a drastic action unlikely to prove popular among both the tradable and non-tradable shareholders. In the context of the Chinese scenario, we think that such draconian measures are unlikely to be politically or socially acceptable at a time when China is anxious to ensure her markets are internationally attractive. Further, transaction costs in the form of administrative costs from the judicial or administrative intermediaries will also impede the economic efficiency of the reform. We do not think that a mandatory transfer rule is preferable to the property rule used in the implemented reform, but do not discount the possibility of its superiority in future cases where the net positive externalities are greater and the political obstacles are fewer.

Policies and laws should not neglect equity in their bid for wealth maximization. Equity mainly concerns the wealth distributional effects and justice issues. Wealth distribution preferences play a crucial role in the setting of entitlements.²⁰⁶ Property rule protection gives a greater

²⁰⁶ Calabresi & Melamed, *supra* note 191, at 1098.

respect to personal autonomy that is important in protecting the subjective value of property.²⁰⁷ Since the property rule is by default a privatized solution, while the liability rule and mandatory transfer rule necessarily involve government administrative or judiciary intermediaries, we now consider the equity factor.

B. Privatized Bargaining Issues

The implemented reform is essentially a privatized bargaining process between the non-tradable and tradable shareholders. The market-based and private bargaining elements of the reform have been repeatedly emphasized in the relevant guidelines and regulations.²⁰⁸ The reform is to be implemented through interest balancing negotiation mechanisms between the non-tradable shareholders and tradable shareholders, essentially employing a privatization solution to the reform.²⁰⁹

There are merits to privatizing this reform. The first is that individual autonomy is respected. This is meritorious because it increases the market and political acceptability of the reform. Similar to democratic elections, participation in the decision-making process allows the parties to better accept outcomes that are not favorable to them, and possible demoralization costs from any loss suffered in the process is likely to be lower as well. Second, privatization achieves a higher degree of efficiency by tapping into the intellectual resources of all the relevant parties.²¹⁰ In contrast to judicial or administrative intermediaries, the “A” shareholders have an intimate knowledge of their specific circumstances. They are also more likely to come up with market innovations that will provide a win-win situation for the parties²¹¹ – after all, it is their personal interests at stake. Third, there is more transparency and less chance of abuse under a privatized reform. “Black box operation” is often

²⁰⁷ *Id.* at 1108.

²⁰⁸ Guiding Opinions, *supra* note 23, ¶ 6, 8; Administrative Measures, *supra* note 55, § 2.

²⁰⁹ Though it may not be immediately apparent, the Chinese implemented reform is actually no different from the usual privatization solution. Privatization usually refers to the giving of property rights to private parties in the context of public goods. However, the essence of privatization is the private bargaining between the parties as opposed to the government administrative allocating resources. Instead of the Chinese government administratively assessing compensation, the tradable shareholders are given the quasi private property right of “anti-trading” (ability to veto the trading of non-tradable shares) which the non-tradable shareholders have to bargain for directly from the tradable shareholders.

²¹⁰ 王国刚, 公共利益: 股权分置改革的理论根据 [Wang Guogang, *Public Interest: Conceptual Basis of Split Share Structure Reform*], 上海证券报[SHANGHAI SECURITIES NEWS] Jan. 20, 2006, at A9, available at <http://www.cnstock.com/ssnews/2006-1-20/default.htm>.

²¹¹ *Id.*

associated with centrally administered reform by government bureaucracies. There is also the risk of abuses and undue influences by the selected few. Letting the relevant parties bargain and decide for themselves averts the deficiencies associated with administrative actions.

Nevertheless, it is important to realize three assumptions underlying privatization: that transaction costs are negligible, that equity is unimportant, and that economic actors are rational.²¹² Because these assumptions do not usually hold true in reality, unless adjustments to the privatization method are made in accordance with how realities differ from these assumptions, privatizing the reform process may actually prove inefficient and ineffective.

1. Negligibility of Transaction Costs

Transaction costs consist of information costs, bargaining costs, and enforcement costs.²¹³ The failure of the Communist-led planned economy has lent strong support to the proposition that government administrative regulation is usually less efficient than private market mechanisms. The failed reform attempt in 2001 further validated the common perception that a reform uniformly administered by the government is not the best solution to the problem.²¹⁴ Nevertheless, administrative allocation of resources is not invariably worse than allocation by private market mechanisms.²¹⁵ This is especially true in circumstances where large numbers of people are involved, resulting in high costs of handling the problem through private bargaining.²¹⁶ In complicated situations which involve multiple constituents, government regulation may actually pose fewer transaction costs than purely private transactions.²¹⁷ The presence of substantial externalities may also dictate government intervention to ensure greater wealth maximization.

As discussed earlier, we think that in the Chinese scenario, privatization under property rule will incur less overall transaction costs compared to the non-privatized means under either the liability rule or mandatory transfer rule. In this case, transaction cost considerations do not alter the superiority of privatization. However, as will be demonstrated in the next part, there is still room for refinement and

²¹² Reza Dibadj, *Regulatory Givings and the Anticommons*, 64 OHIO ST. L.J. 1041, 1097 (2003).

²¹³ Dahlman, *supra* note 197, at 148.

²¹⁴ Luo, *supra* note 22, at 16.

²¹⁵ Coase, *supra* note 198, at 18.

²¹⁶ Dibadj, *supra* note 212, at 1086.

²¹⁷ *Id.*

qualification of the privatization process so as to further reduce transactions costs and improve efficiency.

2. Equity

Coase explicitly prefaced his economic analysis with the important disclaimer, “questions of equity apart.”²¹⁸ Ignoring issues of equity and justice is one of the major limitations of any economic analysis of law.²¹⁹ In our Chinese scenario, the most notable equity issue is that of wealth distribution. The split share structure reform is essentially a redistribution of the interests between tradable shareholders and non-tradable shares.²²⁰ The important question is who should bear the cost of the reform and who should enjoy the benefit.

There has always been considerable sympathy for the holders of tradable shares. After all, unlike those in mature stock exchanges, participants in the Chinese stock markets are usually small-scale individual investors. Before 2001, the proportion of total investment contributed by institutional investors was around 5%.²²¹ That proportion had increased to a healthier 28.52% by 2004, but still falls far short of the proportion in mature capital markets, which is over 50%.²²² Tradable shareholders also suffered significant losses in the stock market due to other institutional and structural deficiencies in the past.²²³ On the other hand, as the state currently owns the majority of the non-tradable shares, there are concerns over the loss of state property through the payment of considerations under the current bargaining mechanisms.²²⁴ Is it equitable that reform costs are paid by the nation’s 1.3 billion people for the benefit of the 70 million tradable shareholders?²²⁵ As discussed in Part II, the Chinese stock market had been plagued by over-speculation, and while the split share structure did contribute to the artificially inflated share prices, the tradable shareholders cannot be absolved of all responsibility in view of their immature and sometimes irrational

²¹⁸ Coase, *supra* note 198, at 19.

²¹⁹ Dibadj, *supra* note 212, at 1087; 王文宇, 民商法理论与经济分析 [WANG WENYU, LEGAL THEORY AND ECONOMIC ANALYSIS OF CIVIL AND COMMERCIAL LAW] 31 (2000).

²²⁰ Tan, *supra* note 68.

²²¹ He, *supra* note 7, at 44-45.

²²² *Id.* at 45.

²²³ Wang, *supra* note 210.

²²⁴ Dan, *supra* note 81, at 25; Xie, *supra* note 109.

²²⁵ *Colloquium in COMMENTS*, *supra* note 75, at 141.

investment behavior,²²⁶ including acting on rumors²²⁷ and blindly following the masses.²²⁸

In Part IV, we showed that tradable shareholders are entitled to compensation by the non-tradable shareholders under the givings doctrine. The question that remains is how this entitlement is to be protected. On the premise that the tradable shareholders are given the entitlement, the property, liability and mandatory transfer rules still have different wealth distribution effects. The property rule and privatization provides for the strongest wealth distribution effects since the tradable shareholders have the right to veto any perceived inadequate compensation. On the other hand, the liability rule and government administered reform has a less advantageous distributive effect for the tradable shareholders since the maximum compensation obtainable is the objectively determined amount, which may be less than their valuation.²²⁹ The mandatory transfer rule is something of a wild card as the rule may be advantageous to either, neither, or both of the parties, depending on the actual circumstances and the parties' characteristics.²³⁰

It is not our purpose to propose which approach would accord more with justice and equity. We merely want to highlight that the issues of equity are not resolved by the privatized reform measures. The perceived effectiveness and merits of the current reform is in no small part dependent on one's preferred approach towards wealth distribution. This is particularly relevant in the context of China, where the often over-zealous emphasis on private market mechanisms can be understood as a reaction to the failure of a planned economy. Unfortunately, this often comes at the expense of social equity. With the rapid widening of the Chinese social gap, such issues of equity cannot be ignored in current and future reforms.

3. Rationality of Economic Actors

Successful privatization requires that relevant economic actors act rationally. The truth is often far from this requirement. Plagued by human behavioral traits, parties in the private bargaining process often

²²⁶张钢钧, A股股权究竟“含”的什么权? [Zhang Gangjun, *Exactly What Kind of Rights Do A-Shares Have?*], 中国经济时报 [CHINA ECON. TIMES], Mar. 30, 2005, available at <http://www.cet.com.cn/20050330/SHELUN/200503302.htm>.

²²⁷ *Id.*

²²⁸ He, *supra* note 7, at 48.

²²⁹ Morris, *supra* note 194, at 853.

²³⁰ *Id.* at 864.

fail to achieve the most efficient allocation of resources. One such relevant behavioral trait is the “endowment effect,” which states that people often demand more to give up a good than to purchase it.²³¹ This behavioral trait is directly applicable to our split share structure reform. Having given the right to veto any trading proposal initiated by the non-tradable shareholders, the tradable shareholders are likely to ask for more compensation than they would otherwise expect or be satisfied with under a liability rule-styled compensation right. Similarly, there is the tendency for parties to conflate what is fair with what is in their favor.²³² This self-serving bias hinders the attainment of a truly efficient win-win bargain. Loss aversion behavior²³³ may also kick in on both the tradable shareholders and non-tradable shareholders such that they are more inclined towards maintaining the status quo than undertaking the risks of reform. Myopic tendencies and indifference about the future²³⁴ may also result in the long term benefits of the reform not being factored into the parties’ calculus, even if those benefits are personally applicable.

A unique feature of the Chinese stock markets further exacerbates the problem of irrationality. As discussed in the previous section, the tradable shares market in China predominantly consists of small-scale individual investors. These tradable shareholders have far fewer resources for information acquisition, information analysis, and decision making than do institutional investors.²³⁵ On the other hand, the non-tradable shareholders are usually either the state itself or corporations. Whether the tradable shareholders can effectively bargain with the non-tradable shareholders to achieve the most efficient outcome for both parties is certainly questionable. It is ironic that while the success of the reform now lies significantly on the shoulders of the tradable shareholders, their limited resources have been identified as among the sustaining factors in the high transaction costs for split share structure reform in the first place.²³⁶

In conclusion, we give due credit to the Chinese authorities for their choice of property rule protection and the privatized bargaining mechanism. However, the inherent limitations of the choices means that the successful implementation of reform is far from guaranteed.

²³¹ Dibadj, *supra* note 212, at 1089.

²³² See Reza Dibadj, *Reconceiving the Firm*, 26 CARDOZO L. REV. 1459, 1489 n.132 (2005); Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1183 (1997).

²³³ Sunstein, *supra* note 232, at 1179.

²³⁴ *Id.* at 1193-1194.

²³⁵ He, *supra* note 7, at 55.

²³⁶ *Id.* at 54.

VI. REFORM RISKS AND RECOMMENDATIONS

A. *Risks of the Reform*

From the above analysis, we are able to identify two distinct areas of risks that may threaten to undermine the efficiency and effectiveness of the reform. First, there is the risk of over-compensation. This risk is comprised of the property rule, behavioral traits and an additional factor of agency costs. Closely related to the first risk, the ability of the tradable shareholders to veto the proposal with a one-third minority disapproval vote also results in a second risk of hold outs.

1. The Risk of Over-Compensation

Three factors contribute to the risk of over-compensation. First, the quasi-property right given to the tradable shareholders puts tradable shareholders in a strong bargaining position. This in itself does not necessarily result in unfair bargaining, as the non-tradable shareholders already have significant advantages from their scale and expertise; however, taken together with the second factor of behavioral traits, in particular the endowment effect, tradable shareholders may demand more in compensation than they actually suffer before giving their approval to a trading proposal. The current reform affirms their sentiment that they were previously treated unjustly and hence deserve compensation, and their right of veto further reinforces this belief. It is easy to imagine that their expected compensation would be significantly lower had the government only granted them the right to seek compensation, but without any say in the trading of non-tradable shares.

The two factors mentioned above cause tradable shareholders to demand more than they otherwise would in terms of compensation. However, over-compensation usually does not take place under normal circumstances, as the other party will not be willing to suffer excessive loss. Here, the third factor of agency costs turns this risk of over-compensation into a reality. Non-tradable shares are either held by corporations or the state, with the state shares being the majority of non-tradable shares. Like companies, the state must rely on its agents to run the state-owned enterprises. The State Council and the local people's

governments act as investors on behalf of the state.²³⁷ The management of the non-vital enterprises is further delegated to the respective state-owned assets supervision and administration authorities.²³⁸ These authorities then appoint “responsible persons”²³⁹ who actually manage the state-owned enterprises.²⁴⁰

It is not surprising that there are major agency-cost problems within China’s multi-level bureaucracy. There have recently been doubts as to whether the popularly accepted mechanisms of managerial incentives, the board of directors and a market for corporate control can effectively reduce agency costs.²⁴¹ As discussed in Part II, there is a severe lack of managerial incentives, in particular long-term incentives, for these responsible persons. The responsible persons usually hold short-term appointments of a few years,²⁴² and usually do not hold any shares in the enterprises.²⁴³ Together with the fact that their performance evaluation is on an annual and office-term basis,²⁴⁴ these responsible persons are heavily inclined to pursue short-term profits at the expense of future risks.²⁴⁵ Similarly, the market for corporate control does not apply to these state shares, and these responsible persons are thus shielded from the pressure to enhance shareholder value.

There is every reason to suspect that these responsible persons may not be particularly concerned about the stock prices that reflect the long-term profitability of the enterprises. Rather, with market reform an important concern for the State-owned Assets Supervision and Administration Authority,²⁴⁶ it is likely that these responsible persons may sacrifice economic viability to keep up with the reform bandwagon. The importance of this split share structure reform and the determination to carry it through has been repeatedly emphasized by the top brass.²⁴⁷

²³⁷ 企业国有资产监督管理暂行条例 [Interim Measures for the Supervision and Administration of State-Owned Assets of the Enterprises] (promulgated by the St. Council, May 13, 2003, effective May 13, 2003) 1090 ST. COUNCIL GAZ. 5, art. 4.

²³⁸ *Id.* at art 6.

²³⁹ 负责人, meaning persons who are responsible for the management of the company.

²⁴⁰ Supervision and Administration of State-Owned Assets, *supra* note 237, art. 16-19.

²⁴¹ Dibadj, *supra* note 232, at 1477.

²⁴² 刘遵义, 国企改革双重难题 [Liu Zhunyi, *Two Difficulties in the Reform of State-owned Enterprises*], 145 财经 [CAIJING MAG.] 80 (2005).

²⁴³ *Id.*

²⁴⁴ Supervision and Administration of State-Owned Assets of Enterprises, *supra* note 237, art. 18.

²⁴⁵ Liu, *supra* note 242.

²⁴⁶ *E.g.*, Supervision and Administration of State-Owned Assets, *supra* note 237, arts. 13(2), 14(4).

²⁴⁷ See Liu Pengru, Chief Chairman of the China Securities Regulatory Commission, *Foreword* in He, *supra* note 7, 1; 国务院 2006 年工作要点 [State Council Work Targets for 2006] (promulgated

The rarity and stigma of a rejected trading proposal also means these responsible persons will go all-out to guarantee the success of their trading proposals. It certainly does not help that these responsible persons do not personally foot the bill for compensating the other party, and there is a real chance that they may over-compensate to secure the tradable shareholders' approval.

The requirement of approval by the State-owned Assets Supervision and Administration Authority²⁴⁸ does help to mitigate risk. This additional check reflects the major Chinese regulatory authorities' concerns regarding the preservation of state-owned assets.²⁴⁹ We acknowledge the merit of this administrative check; however, we must point out the limitations inherent in self-checking since the regulatory authority granting the approval is the same authority that manages the state-owned enterprises. The political pressure to ensure the success of the reform implementation can only be greater for this authority than for its agents, weakening the effectiveness of this check.

2. The Risk of Holding Out

A common risk of using the property rule in resource allocation is the risk of holdouts. Tradable shareholders may hold out for a better deal since they possess a veto right. The two-thirds majority requirement, as opposed to a requirement of unanimous consent, does help to alleviate the problem because a greater number of holdouts is needed to block a potentially reasonable and efficient trading proposal, but the risk is still significant.

Arguably the tradable shareholders do not need, or even desire, the trading of non-tradable shares. The whole idea of payment of consideration is to compensate their loss. While the trading of the non-tradable shares may increase share values in the long run due to its

by St. Council, Mar. 19, 2006, effective Mar. 19, 2006), ¶ 32, stating that the split share structure reform should be basically completed in 2006, *available at* http://www.gov.cn/zwggk/2006-03/22/content_233622.htm; 关于上市公司股权分置改革中国有股股权管理有关问题的通知 [Circular of the State-owned Assets Supervision and Administration Commission of the State Council on Relevant Issues Concerning the Administration of the Stock Right of State-owned Shares in the Share-trading Reform of Listed Companies] (promulgated by State-owned Assets Supervision and Administration Commission, Sep. 8, 2005, effective Sep. 8, 2005), §§ 1-2, stressing that the reform must be proactively implemented, *available at* www.china.com.cn/chinese/zhuanti/jjgq/966376.htm; Shang Fulin, Chairman of China Securities Regulatory Commission, *Comment*, in He, *supra* note 7, at 13, publicly stating that the reform is "like an arrow with no turning back."

²⁴⁸ Administrative Measures, *supra* note 55, § 15.

²⁴⁹ *E.g.*, Supervision and Administration of State-Owned Assets, *supra* note 237, art. 11, 13(5), 35.

benefits toward better corporate governance, the tradable shareholders will be more concerned about the immediate drop in share prices after the trading proposal is implemented. As discussed earlier, the main form of profit for the tradable shareholders is the speculation on the price difference, and not long-term investment returns. One of the purposes of this split share structure reform is to change this deficiency in the Chinese stock market. But the current speculative mentality of the tradable shareholders means that they will be more concerned about short-term share price fluctuations than corporate governance benefits from the split share structure reform. In the same vein, the majority of tradable shareholders, being small-scale individual investors, are not at all interested in the prospect of acquiring the company after the trading of non-tradable shares. The behavior trait of loss aversion also makes holding out an attractive option for tradable shareholders.

B. Recommendations

The following recommendations will improve the efficiency and effectiveness of the reform. These recommendations are designed to tackle both of the risks discussed earlier. The reduction of transaction costs is also an important efficiency consideration underlying our recommendations. We do not deny that the implementation of these recommendations has its own costs as well – there are inevitable trade-offs in the process – but we believe these recommendations will have an overall net positive benefit. These recommendations will also be useful in any future charging of givings by the direct compensation of parties.

1. Third Party Appraisal Mechanisms

Under the current reform regime, the non-tradable shareholders have to wait three months before they may reapply if their trading proposal is not approved the first time around.²⁵⁰ In light of the risks of tradable shareholders holding out, there is no guarantee that the trading proposal will succeed during the second round. Each trading proposal submission involves significant administrative, legal and other costs. The mandatory ten-day communication period between the non-tradable shareholders and tradable shareholders prior to the voting²⁵¹ significantly helps ensure its approval. In fact, only eight out of the several hundred trading proposals submitted for voting had been rejected as of March

²⁵⁰ Administrative Measures, *supra* note 55, § 18.

²⁵¹ *Id.* § 10.

2006.²⁵² However, there is still the risk of unreasonable holding out or withholding of approval by the tradable shareholders, which will result in considerable waste of time and money. The risk of over-compensation is also significantly increased after each failed attempt at trading. In addition, the bargaining process may suffer an irrevocable breakdown due to either mistrust or prior misgivings between the parties. For example, one reason that contributed to the rejection of the Qing Hua Tong Fang trading proposal is the tradable shareholders' repugnance with the non-tradable shareholders' arrogant attitude. This resulted in the rejection of a proposal that was actually a better-than-average compensation package.²⁵³

A third party appraisal mechanism will help to break the deadlock in such circumstances. This appraisal mechanism is not meant to replace or supplant the private bargaining mechanism. Rather, it is designed to provide a resolution of last resort after repeated failed negotiations; the parties should only have the right to utilize this mechanism after two failed attempts at the usual process. This mechanism will prevent unreasonable holdouts or irrevocable breakdowns in negotiations from obstructing the reform process. It is a valid concern that the availability of this mechanism will actually hinder the bargaining process. The parties may not willingly or actively negotiate or make compromises since they can simply resort to this mechanism in the event of a failed negotiation. Nonetheless this can be resolved by stipulating that the appraisal will also take into account whether the parties have acted unreasonably or in bad faith. The outcome of the appraisal will be deliberately less favorable to the parties that are at fault in the negotiation process. This will provide an incentive for the parties to negotiate actively and in good faith, and will also help reduce the perceived need for over-compensation by those eager to ensure trading because of political pressures.

The appraisal mechanism will promote overall economic efficiency by effectively switching to a liability rule to handle cases where the parties' bargaining costs are excessively high. One such case is where the company's shareholding structure allows a group of tradable shareholders to exercise actual control over the exercise of the veto despite comprising only a minority of total tradable shareholders, which

²⁵² 姚毅, 裕丰股份股改为何功败垂成 [Yao Yi, *Why the Share Reform of Yu Feng Failed*], 中国证券报 [CHINA SEC. J.], Mar. 4, 2006, at A12, available at http://www.cs.com.cn/jrbznew/html/2006-03/04/content_470956.htm.

²⁵³ 黄建中, 股改博弈谁是“冤大头” [Huang Jianzhong, *Who is the “Wastrel” in Share Reform?*], 中华工商时报 [CHINA BUS. TIMES], Feb. 6, 2006, available at <http://www.cbt.com.cn/cbtnews/frontend/news.asp?ID=81126>.

was the case of the rejected Yu Feng Gu Fen trading proposal. The tradable shareholdings of the company were in that case extremely diverse, with 16,000 shareholders holding a total of 40 million shares. However, only a total of 979 tradable shareholders with a combined shareholding of 20.36% took part in the voting.²⁵⁴ The vast majority of tradable shareholders did not vote, as their personal transaction costs outweighed their personal stakes. This is precisely the sort of situation where the high transaction cost of privatized bargaining under the property rule impedes efficient transfers. Appraisals under the liability rule would actually lead to greater economic efficiency in such cases.

2. Guidelines for the Bargaining Process

As highlighted earlier, the privatization solution, while meritorious, fails to adequately deal with considerations of transaction costs, fairness, and the parties' irrationality. Currently, the tradable shareholders and non-tradable shareholders are basically given free rein to bargain without any guidelines save the requirement of approval by the relevant authorities.²⁵⁵ There are only vague guidelines to "give attention concurrently to the immediate interests and the long-term interests of all the shareholders . . . for developing the company and stabilizing the market"²⁵⁶ and "balance the interests of the shareholders by way of consideration."²⁵⁷ Of course, any uniformly applied mandatory reform measures or guidelines are likely to prove disastrous, considering the different circumstances of each listed company. However, this does not mean that the government should not set down some guidelines for the bargaining process. One of the most important purposes for these

²⁵⁴ Yao, *supra* note 252.

²⁵⁵ There are reports that Cao Lubo, an assistant researcher in the Chinese State Council State-owned Assets Supervision and Administration Commission, Bureau of Property Right Management Shares Department, publicly announced six major principles for the determination of considerations. 对价六原则: 国资委设 "PK 台" ? [Six Principles for Consideration: SASAC Setting the "PK Stage"?], 21 世纪经济报道 [21ST CENTURY ECON. REP.], Sep. 26, 2005, available at <http://www.nanfangdaily.com.cn/jj/20050926/zh/200509260005.asp>. The announcement was made after the completion of the second trial where all the trading proposals were approved. This led to concerns of over-compensation for state shares. There are two problems with this six principles announcement. First, it was an unofficial announcement that was not even recorded in the State-owned Assets Supervision and Administration Commission website, <http://www.sasac.gov.cn/index.html> (last visited Oct. 27, 2006). Its applicability is certainly in doubt. Second, there are enforcements problems. These six principles can at best affect the granting of approval by the State-owned Assets Supervision and Administration Authority, but do not affect the exercise of veto rights by tradable shareholders.

²⁵⁶ Administrative Measures, *supra* note 55, § 22.

²⁵⁷ Guiding Opinions, *supra* note 23, ¶ 8.

guidelines would be to tackle the equity considerations ignored under privatization. For example, these guidelines may stipulate the various considerations that must be factored into the private bargaining process. This includes factors like externalities, long-term benefits and detriments and historical losses and gains that may not be within the parties' bargaining calculus.

Some qualifications should also be imposed on the exercise of the tradable shareholders' rights in the reform to ensure they are not exercised unreasonably or in bad faith. This is related to the previous recommendation and is meant to reduce transaction costs and negative externalities. The objections to this qualification should be limited since this right is granted to the tradable shareholders by regulation in the first place.

The enforcement of these guidelines can take the form of a reduction in the required majority approval. For example, if the non-tradable shareholders discharge the burden of showing that their proposal properly took into account the various stipulated considerations, they should be able to implement that proposal with only a simple majority by the tradable shareholders, instead of the currently required two-thirds majority. This is a useful incentive to encourage trading proposals that generate positive externalities. These guidelines could also help reduce the risk of over-compensation. As discussed above, one reason contributing to this risk is the pressure to secure the tradable shareholders' approval. By lowering the approval requirement when the trading proposal meets certain guidelines, the non-tradable shareholders, especially that of the state shares, would be less inclined towards over-compensation.

VII. CONCLUSIONS: LESSONS ON CHARGING GIVINGS

The Chinese split shares structure reform is complicated and difficult. The experience of the failed 2001 reform largely contributed to the innovative privatized bargaining mechanisms whereby the tradable shareholders must be satisfied by the non-tradable shareholders' compensation package before the non-tradable shares can trade. We give due credit to the Chinese regulatory authorities for this granting of property rights and use of a privatized solution that accords with economic efficiency and practicality of implementation. However, on the legal front, the traditional approaches in private and public law remedies have failed to provide a valid legal basis for the payment of compensation by non-tradable shareholders to tradable shareholders. This reflects the difficulty in maintaining a strict public-private dichotomy. Nonetheless,

the givings doctrine born only recently on the other side of the Pacific Ocean provides doctrinal support for China's reform. Yet, the reform itself demonstrates a new type of givings and also provides important lessons and guidance in the charging of givings.

A. *Givings Subject to a Condition Precedent*

There are two ways of analyzing the nature of the givings doctrine in the implemented Chinese reform. Both approaches represent significant departures from the givings doctrine originally proposed by Bell & Parchomovsky. One view is to see the givings doctrine as providing tradable shareholders a right to compensation from the non-tradable shareholders for the lifting of trade restrictions. The privatized bargaining mechanism utilizes the property rule, as opposed to the liability rule, to protect this right to compensation. Bell and Parchomovsky did not envision this reliance on the property. While they did suggest that the charge should be made directly between the parties,²⁵⁸ it is ironic that they only provided the example of government-mediated private takings.²⁵⁹ Private takings necessarily involve government intermediaries,²⁶⁰ running contrary to their claim of transaction costs saving through doing away with the "largely unnecessary intermediary role of the government."²⁶¹ Even the suggested use of "self-assessment" to reduce administrative costs is confined to assessments of the charge and not intended to operate where givings beneficiaries make payments directly to takings victims.²⁶² Indeed, reading the article as a whole, it appears that when they proposed direct payment from givings beneficiaries to takings victims, they were only referring to the act of payment.

This is rather surprising since the efficiency and corrective justice benefits to which they alluded are actually more effectively upheld by the mechanism of Chinese privatized bargaining, a classic property rule protection. The intermediary role of the government is largely secondary, even under our recommendations which propose some government intervention into the privatized bargaining process. Similarly, the

²⁵⁸ Bell & Parchomovsky, *Givings*, *supra* note 6, at 601.

²⁵⁹ *Id.* at 599-600.

²⁶⁰ Private taking is a liability-rule protection, *Id.* at 600, which by implication requires a third parties' objective determination of the property value. See also Charles E. Cohen, *Eminent Domain After Kelo v. City of New London: An Argument for Banning Economic Development Takings*, 29 HARV. J.L. & PUB. POL'Y 491, 535-536 (2006).

²⁶¹ Bell & Parchomovsky, *Givings*, *supra* note 6, at 600.

²⁶² *Id.* at 607.

Chinese privatized bargaining mechanism places both the payment and the assessment of the charge directly into the hands of the relevant parties. This more closely adheres to the spirit of corrective justice.²⁶³ The risks of under-compensation commonly associated with private takings²⁶⁴ are also adequately dealt with by the granting of veto rights to tradable shareholders.

The utilization of property rule protection under the privatized bargaining process in Chinese reform demonstrates a novel and effective manner of charging the givings. Yet the concept of property rule protection is considered the antithesis of government takings in the first place. The basic premise of government takings is that it does so by paying compensation assessed by the courts, a classic liability rule protection. The granting of veto power to the tradable shareholders in the privatized bargaining process before the giving takes place can be seen not only as property rule protection for the right to compensation, but also as a giving of a different nature. This other view of the givings doctrine in the Chinese implemented reform focuses on this condition precedent of the government's givings.²⁶⁵ Unlike the charging of givings proposed by Bell and Parchomovsky, which requires the beneficiaries of the giving to pay the charge before the acceptance of the benefits, China's reform requires as a pre-condition that non-tradable shareholders obtain the consent of the tradable shareholders before the regulatory authorities lift the trading restrictions. In essence, the Chinese implemented reform represents a conditional giving.

This aspect of China's reform is a particularly interesting variation of the givings doctrine, given that the condition is the success of private bargaining. Echoing the aforementioned observations about the blurring of the public-private distinction,²⁶⁶ this incorporation of the private bargaining condition infuses an element of private law into the essentially public nature of the original givings doctrine. This is certainly a meritorious and welcome development, and our economic analysis has affirmed the merits of this arrangement.²⁶⁷ The purposes of China's reform, including enhancing respect for market order, promoting the market's stability and development, and safeguarding investors' legal

²⁶³ *Id.* at 600 ("Corrective justice requires that individuals who wrong others compensate the victims for their losses").

²⁶⁴ Cohen, *supra* note 260, at 537 (referring to eminent domain practices which the author explicitly stated at 533 to include both true public takings and private takings).

²⁶⁵ Givings here is in the form of lifting trading restrictions, akin to up-zoning.

²⁶⁶ See *supra* Part III.C.

²⁶⁷ See *supra* Part V.

rights,²⁶⁸ are also better served by adopting a more innovative and flexible combination of the remedies from the arenas of both public and private law.

B. Implications for the Charging of Givings

The economic analysis of the Chinese implemented reform underscores the deficiencies of a rigid entitlement protection rule. Strict property rule protection without the implemented reform requirements of regulatory approval and the two-third majority would have resulted in significant risks of over-compensation and holding out. The reform risks we have identified and the recommendations we have proposed further emphasize the merits of a composite entitlement protection rule in dealing with the real world, which is far more complex than the hypothetical world of economic models. This is particularly relevant in determining the manner of charging the givings. When faced with charging for givings in the future, government authorities should be wary of the limitations in traditional entitlement protection rules and be open to innovative measures that are more suited to individual circumstances. This may even sometimes involve the creation of new entitlement protection rules, such as a property rule with a built-in mechanism that switches to liability rule when high transaction costs impede the operation of property rule,²⁶⁹ or a qualified property rule where the exercise of property rights is subjected to certain perimeters and guidelines.²⁷⁰

Another significant aspect of the Chinese reform, especially in the context of the U.S. takings doctrine, is the Chinese recognition of the right to compensation in the context of derivative takings. Tradable shareholders are victims of derivative takings when trading restrictions on the non-tradable shares are lifted. They do not have any right to compensation, even under the more developed U.S. takings doctrine.²⁷¹ Yet under the various regulations related to the Chinese reform, the tradable shareholders not only have the right to compensation but are also able to veto if they are not satisfied with the compensation. The rhetoric of the reform did not suggest that doctrinal significance of derivative takings was an important consideration to the Chinese regulatory authorities. Moreover, we do not suggest that compensation under derivative takings is now part of the Chinese law. Nonetheless, we

²⁶⁸ Guiding Opinions, *supra* note 23, ¶ 6.

²⁶⁹ See *supra* Part VI.B.1.

²⁷⁰ See *supra* Part VI.B.2.

²⁷¹ See *supra* Part III.B.3.

believe that China's reform sets an illustrative precedent for compensation in derivative takings that will have practical implications and influence on future Chinese reforms.²⁷² This also provides useful guidance to the U.S. takings doctrine, where the current law fails to deal with the unfairness and inefficiency of uncompensated derivative takings.²⁷³

In conclusion, the Chinese split share structure reform has been a fruitful application of the givings doctrine. The Chinese innovation of using privatized bargaining mechanism provides a practical alternative manner of charging givings aside from private takings in situation where the relationship of the takings and givings is highly proximate. Our economic analysis also unveils possible innovations in entitlement protection that may help further ensure the efficiency and fairness of charging givings. In addition, the hybrid public-private nature of the whole process as demonstrated by the Chinese implemented reform must be taken note of to ensure compliance with the existing public-private law framework. All these provide useful practical guidance when implementing the givings doctrine in future cases, and we hope this useful doctrine will continue to be incorporated in future government policies, regulations and reforms.

²⁷² For example, the victims of future derivative takings will point to this Chinese implemented reform when demanding compensation.

²⁷³ See Bell & Parchomovsky, *Takings Reassessed*, *supra* note 140, at 289-292.