LIFTING THE VEIL OF WORDS: AN ANALYSIS OF THE EFFICACY OF CHINESE TAKEOVER LAWS AND THE ROAD TO A "HARMONIOUS SOCIETY"

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Abstract

Empirical evidence shows that takeovers are value-maximizing events for target firm shareholders and promote social efficiency. Takeovers are commonly thought to play a key role in reducing managerial slack in corporate governance through the replacement of inefficient management. Additionally, a multitude of economic literature indicates that synergy can result in the value of a combined firm that exceeds the sum of the values of two individual firms. But despite the potential for a value-creation event, takeovers rarely happen in China's capital market. One reason for this phenomenon is that Chinese takeover laws have a chilling effect on potential corporate raiders. The pro-state-owned enterprise (SOE) approach of the China Securities Regulatory Commission (CSRC) further deters potential takeovers. This pro-government approach comes at the cost of non-SOE shareholders' opportunities for value maximization.

Nonetheless, since the Chinese government's policy focus has shifted from protecting state-owned assets to promoting social equity, we can expect the CSRC's regulatory approach to undergo significant changes as well. And in accordance with the change in the government's core values, many takeover provisions need to be amended to facilitate value creation events at both state-owned and privately-owned firms.

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INTRODUCTION

Although no single theory is sufficient to explain all takeovers, empirical evidence consistently demonstrates that takeovers can be value-maximizing events for target firm shareholders and enhance social efficiency.[1] Acquisition of control rights by ousting original management is commonly thought to play a key role in reducing managerial slack in corporate governance by replacing inefficient management.[2] Moreover, economic literatures have argued that the value of the combined firm is greater than the sum of values of the two individual firms, as successful takeovers create synergy gain.[3]

In China, however, few takeovers are ever initiated.[4] As a result, management is insulated from threats of replacement by takeovers. The infrequency of takeovers in China can be explained by the chilling effect of Chinese takeover laws and the pro-government stance of the China Securities Regulatory Commission (CSRC),[5] the primary regulator of China's securities markets. In 2002, the Chinese legislature released its first takeover-specific regulation,[6] which contains many provisions that may initially appear

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[1] Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 YALE J. ON REG. 119, 119–20 (1992).

[2] *Id.* at 130–33; John Armour & David Skeel, *Who Writes the Rules for Hostile Takeovers and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1735, 1727 (2007) (discussing the features of common law takeover regulation from a comparative law perspective and explaining how the takeover market is a typical source of market discipline for management). If management were not diligent, the firm's value would stagnate. In the face of potential bidders who threaten to buy the company and replace the management, senior officers would be incentivized to enhance their performance and maximize the firm's value.

[3] *See, e.g.*, J. FRED WESTON, KWANG S. CHUNG & SUSAN E. HOAG, MERGERS, RESTRUCTURING AND CORPORATE CONTROL 93–94, 191–92 (2d ed. 1990).

[4] PENG BING (彭冰), Zhongguo Zhengquan Faxue (中国证券法学) [CHINESE SECURITIES LAW] 268, 286 (2007). *See also* Benjamin Chun, *A Brief Comparison of the Chinese and United States Securities Regulations Governing Corporate Takeovers*, 12 COLUM. J. ASIAN L. 99, 121 (1998).

[5] CSRC, Zhengjianhui Luoshi Guowuyuan Fangdichan Tiaokong Zhengce Guifan Fangdichan Binggou Chongzu (证监会落实国务院房地产调控政策规范房地产并购重组) [CSRC Implements State Council Policy on Controlling the Real Estate Market and Regulating Mergers, Acquisitions, and Reorganizations of Real Estate Enterprises], Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Gonggao (中国证券监督管理委员会公告) [CSRC Official Bulletin] (2010), *available at* http://www.gov.cn/gzdt/2010-10/15/content_1723806.htm.

[6] Shangshi Gongsi Shougou Guanli Banfa 2008 Xiuding (上市公司收购管理办法 2008 修订) [Measures for the Administration of the Takeover of Listed Companies 2008 Amendments] (promulgated by the CSRC, Aug. 27, 2008, effective Aug. 27, 2008) (Lawinfochina), http://www.lawinfochina.com/display.aspx?id=7043&lib=law [hereinafter Measures for Administration of Takeovers].

shareholder-friendly.[7] But the low number of takeovers, whether tender offers or hostile takeovers, suggests that the takeover laws have thus far deterred consummation of takeover transactions and have not promoted effective corporate governance.

The historical domination of capital markets by state-owned enterprises (SOEs) and the special administrative features of the CSRC explain why the legislature would be interested in deterring unscrutinized takeover actions. Before 2002, almost all companies on the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) were SOEs or firms reorganized from SOEs.[8] Decisions regarding mergers, acquisitions, and stewardship changes of SOEs are determined by the State-Owned Assets Supervision and Administration Commission (SOASAC) of the State Council.[9] Over the last decade, however, the capital structure of the market has changed: an increasing number of central and local SOASAC offices have reduced their stock ownership in the market to optimize listed companies' operational efficiencies.[10] This may be due to a realization by the central government that it is inefficient for it to continue to simultaneously operate as a market player and a referee. More importantly, the government's focus has shifted from the facilitation of "SOE Reform" (国有企业改革) (*guoyouqiye gaige*)[11] to a

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[7] *See, e.g.*, Zhang Yuanchun & Li Shanmin (张媛春 & 李善民), Qiangzhi Yaoyue Zhidu yu Zhongxiao Touzizhe Baohu (强制要约制度与中小投资者保护) [*Mandatory Bid and Minority Shareholder Protection*], Jingji Guanli (经济管理) [ECON. MAN. J.], no. 6, 2009, at 77. *See also* Ma Qijia (马其家), Oumeng Qiangzhi Yaoyue Guize ji Qishi (欧盟强制要约规则及启示) [*The European Union's Mandatory Bid Rule and Its Lessons*], Zhengquan Shichang Daobao (证券市场导报) [SEC. MARKET HERALD], no. 55, 2007, at 9.

[8] Tu Biyu (涂必玉), Shangshi Gongsi Guquan Jiegou yu Xianjin Guli Fenpei Zhengce Guanxi Tanxi (上市公司股权结构与现金股利分配政策关系探析) [*An Analysis of the Relationship Between Capital Structure of Listed Company and Cash Dividend Policy*], Jingji Zhongheng (经济纵横) [ECON. R.], no. 2, 2011, at 92. *See also*, Gugai Qianhou Woguo Shangshi Gongshi Guquan Jiegou Jiben Tezheng de Bijiao Fenxi (股改前后我国上市公司股权结构基本特征的比较分析) [*Comparison of Basic Characters of Capital Structure of Listed Company Before and After Equity Structure Reform*], Shangye Shidai (商业时代) [COM. TIMES], no. 19, 2010, at 42 (discussing capital structure of listed companies in recent years).

[9] Guoziwei Chutai Yangqi Renshi Renmian Xingui (国资委出台央企人事任免新规) [*SOASAC Enacted a New Appointment Regulation*], Juece yu Xinxi (决策与信息) [DECISION & INFO.], no. 2, 2012, at 7 (2012).

[10] Peng Hongfeng & Wang Jinjing (彭红枫 & 王金晶), Qianxi Kezhuan Zhaiquan zai Woguo Guoyougu Jianchi Zhong de Zhuoyong (浅析可转换债券在我国国有股减持中的作用) [*An Analysis of the Function of Convertible Bonds in State Shareholding Reduction*], Shengchanli Yanjiu (生产力研究) [PRODUCTIVITY RES.], no. 8, 2006, at 207, 207–8.

[11] Lixin Colin Xu, Tian Zhu & Yi-min Lin, *Politician Control, Agency Problems, and Ownership Reform: Evidence from China*, 13 ECON. TRANSITION 1, 2 (2005), *available at* http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0351.2005.00205.x/pdf. "SOE Reform" refers to "the large-scale ownership and organizational reform of Chinese SOEs during

"harmonious society" (和谐社会) (*hexie shehui*).[12] Such a fundamental policy shift calls for the CSRC to rethink its approach to market supervision.

This Article seeks to discern the underlying policy rationale of the current takeover regulations and proposes a new approach for market regulation. It offers suggestions on improving several specific takeover provisions under this new approach. Part I of the Article examines the current takeover laws from a regulatory perspective and introduces the principal provisions on market regulation and private enforcement. Part II analyzes the role of the market rule-maker, the CSRC, its philosophy, and the incarnations of this philosophy in the takeover regulations. Part III discusses the practical implications of current takeover laws from the perspective of shareholder protection and market development and concludes with an assessment of the overall efficacy of Chinese takeover regulations. Finally, Part IV proposes a new market regulatory framework that is more in tune with changes in the market's landscape and in central government's policy. It then suggests specific amendments to takeover law provisions in light of the proposed framework.

I. TAKEOVER LAWS

The Chinese takeover regulatory system defines the conditions and legal procedures for takeover activities and fiduciary duty. Because China is a civil law jurisdiction where precedents have no binding power[13] and legal rules are affected by changing social rules,[14] the legislature or its designated agencies are responsible for explaining and interpreting statutes. Paragraph 2 of Article 101 of the Securities Law stipulates that "[t]he securities regulatory authority under the State Council shall formulate specific measures for the acquisition of

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the 1990s represent[ing] the government's attempts to address politician control and agency problems. . . . The reforms were propelled by the fact that SOEs' financial performance steadily deteriorated during the 1990s after a period of improved productivity in the 1980s." *Id.* The reform adopted two major strategies: privatization and corporatization.

[12] *See* Maureen Fan, *China's Party Leadership Declares New Priority: 'Harmonious Society': Doctrine Proposed by President Hu Formally Endorsed*, WASH. POST, Oct. 12, 2006, at A18, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/10/11/AR2006101101610.html. The construction of a "harmonious society" is a socio-economic vision that is said to be the result of President Hu Jintao's signature "Scientific Development" ideology. In applying this vision, Chinese authorities have responded to social unrest by tightening controls and drafting laws to placate society's ire towards corrupt government and corporations.

[13] *See* SHEN ZONGLING (沈宗灵), Bijiaofa Yanjiu (比较法研究) [RESEARCH ON COMPARATIVE LAW] 142 (1998) (arguing that China falls within the family of continental law countries, also known as civil law countries, where the main source of law is statutes and where judicial precedents have hardly any binding effect).

[14] William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 278 (1992).

listed companies according to the principles of the present Law."[15] It authorizes the CSRC, the securities regulatory agency under the State Council, to explain and promulgate specific rules pursuant to the general principles of the Securities Law.[16]

In practice, rules promulgated by the CSRC have sometimes conflicted with the Securities Law,[17] and it is unclear whether the CSRC's explanations are binding over the Securities Law. As these issues are still unresolved, basic principles of the Securities Law remain elusive.[18] Conflicting interpretations of the Securities Law may lead to starkly different litigation outcomes. This ambiguity often leaves judges with significant discretion in selecting applicable rules in securities litigation. Take fiduciary duty, an imported but popular concept in Chinese business law, for example.[19] The legislature has adopted this duty not only in corporate law but also in securities law and its related measures.[20] Although the legislature has repeatedly incorporated this

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[15] Zhengquan Fa (证券法) [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) art. 101, 2005 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 586 [hereinafter Securities Law], *available at* http://www.gov.cn/flfg/2005-10/28/content_85556.htm.

[16] *Id.*

[17] *Id. See also* Measures for Administration of Takeovers, *supra* note 6. The most controversial conflict in the takeover context is between Article 96 of the Securities Law and Article 47 of the Measures. *See infra* Part I.A.2.a.

[18] PENG, *supra* note 4, at 272–73.

[19] *See, e.g.*, Charlie Xiao-chuan Weng, *Assessing the Applicability of the Business Judgment Rule and the "Defensive" Business Judgment Rule in the Chinese Judiciary: A Perspective on Takeover Case Adjudications*, 34 FORDHAM INT'L L.J. 124, 129 (2010) (discussing transplantation of fiduciary duty).

[20] *See, e.g.*, Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, amended Oct. 27, 2005, effective Jan. 1, 2006) art. 148, 2005 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 548 [hereinafter Company Law], *available at* http://www.gov.cn/ziliao/flfg/2005-10/28/content_85478.htm ("The directors, supervisors and senior managers shall comply with the laws, administrative regulations, and bylaw. They shall bear the obligations of fidelity and diligence to the company."); Securities Law, *supra* note 15, art. 152 ("Where any director, supervisor or senior manager of a securities company fails to fulfill his fiduciary duties and thus incurs any major irregularity or rule-breaking act or major risk to his securities company, the securities regulatory authority under the State Council may revoke the post-holding qualification thereof and order his company to remove him from his post and replace him with a new one."); Measures for Administration of Takeovers, *supra* note 6, art. 8 ("The directors, supervisors and senior managers of a target company shall assume the obligation of fidelity and diligence, and shall equally treat all the purchasers that intend to take over the said company. The decisions made and the measures taken by the board of directors of a target company for the takeover shall be good for maintaining the rights of the company and its shareholders, and shall not set any improper obstacle to the takeover by misusing its authorities, nor may it provide any means of financial aid to the purchaser by making use of the sources of the target company or damage the lawful rights and interests of the target company or its

notion into takeover-related regulations, most of their efforts overlap and are too abstract to be applied to fiduciary duty adjudication with specificity and precision. As discussed below, other areas of the takeover laws are similarly plagued with ambiguity and conflicting interpretations.

A. Takeover Regulations

1. Disclosure Requirements

Compliance with disclosure and procedural rules governing tender offers is principally regulated by the CSRC. The CSRC has promulgated a set of onerous and complicated disclosure requirements named "Measures for the Administration of the Takeover of Listed Companies" (the "Measures").[21] The most infamous rule is the "5% Rule," which requires a purchaser to disclose every 5% increase in its ownership of a company's stock when acquiring a block of shares, whether or not the acquisition is part of a takeover.[22] The

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shareholders."); Qiye Pochan Fa (企业破产法) [Enterprise Bankruptcy Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug 27, 2006, effective June 1, 2007) art. 27, 2006 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 561, *available at* http://www.lawinfochina.com/display.aspx?id=5425&lib=law ("A bankruptcy administrator shall be diligent and dutiful, and shall faithfully perform its duties as well.").

[21] *See* Measures for Administration of Takeovers, *supra* note 6.

[22] Article 86 of the Securities Law states:

> When an investor, through securities trading at a stock exchange, comes to hold individually or with any other person 5% of the shares as issued by a listed company by means of agreement or any other arrangement, the investor shall, within three days as of the date when such shareholding becomes a fact, submit a written report to the securities regulatory authority under the State Council and the stock exchange, notify the relevant listed company and announce the fact to the general public. Within the aforesaid prescribed period, the investor may not purchase or sell any more shares of the listed company.
>
> Once an investor holds individually or with any other person 5% of the shares as issued by a listed company by means of agreement or any other arrangement, he shall, pursuant to the provisions of the preceding paragraph herein, make a report and announcement for each 5% increase or decrease in the proportion of the issued shares of the said company he holds through securities trading at the stock exchange. Within the reporting period as well as two days after the relevant the report and announcement are made, the investor may not purchase or sell any more shares of the listed company.

Securities Law, *supra* note 15, art. 86.

main purpose of the rule is to raise a red flag and inform the market that there is an active potential bidder.[23]

The implementation of this disclosure requirement varies depending on whether the purchaser buys shares in the open market or through a private agreement. Under Article 86 of the Securities Law and Article 13 of the Measures,[24] a purchaser in the open market is required to report and stop buying additional shares from the exchange once it has acquired 5% of the target company's stock. The purchaser must report its stockholding to the CSRC and immediately disclose this information to the market. Additionally, the purchaser may not buy any additional shares within three days of the disclosure. For each subsequent 5% increase or decrease in its ownership of the company's outstanding shares, the purchaser is prohibited from buying or selling shares within two days after the disclosure. In other words, a purchaser must stop and disclose its purchase activities when reaching 5%, 10%, 15%, 20%, 25%, and 30% stockholding marks.[25]

In contrast, the statutory language on disclosure requirements in a private purchase suggests that only one disclosure is required. The first paragraph of Article 14 of the Measures stipulates:

> If the shares whose entitlements are held by an investor and its concerted parties reach or exceed 5% of the issued shares

[23] PENG, *supra* note 4, at 269.

[24] Measures for Administration of Takeovers, *supra* note 6, arts. 13–14; Securities Law, *supra* note 15, art. 86. Articles 13 and 14 of the Measures are elaborations of Article 86 of the Securities Law. Article 13 of the Measures concerns the disclosure requirement when takeover occurs through the open market operation. It provides:

> If the shares whose entitlements are held by an investor and its concerted parties reach 5% of the issued shares of a listed company through the securities transactions at the stock exchange, they shall formulate a report on the alteration of share entitlements within 3 days after the said fact occurs, submit a written report to the CSRC and the stock exchange, send a copy of the said report to the CSRC representative office at the locality of the listed company (hereinafter referred to as the representative office), notify the listed company and announce it to the general public; and they shall not buy or sell the stocks of the said listed company again within the aforesaid term.
>
> After the shares whose entitlements are held by the aforesaid investor and concerted parties reach 5% of the issued shares of the listed company, if the proportion of the shares whose entitlements are held by them to the issued shares of the listed company increases or reduces by 5% each time through the securities transactions at the stock exchange, they shall give a report and make an announcement according to the preceding Paragraph, and shall not buy or sell the shares of the said listed company again within the reporting period or within 2 days upon reporting and announcement.

Measures for the Administration of Takeovers, *supra* note 6, art. 13.

[25] When a bidder acquires 30% of the target company's share, the "mandatory bid rule" is triggered. *See* discussion *infra* Part I.A.2.a.

> of a listed company by means of transfer agreement, they shall formulate a report on the alteration of share entitlements within 3 days after the said fact occurs, submit a written report to the CSRC and the stock exchange, send a copy of the said report to the representative office, notify the listed company of it, and make an announcement on it.[26]

Here, the CSRC adopted the phrase "reach or exceed 5%," instead of "reach 5%," the language used under Article 13 for open market purchases. Thus, if a purchaser makes a one-time purchase of 20% of issued shares of the target company through a private agreement, it is only required to make one disclosure. This seems straightforward so far. But in the second paragraph of Article 14 of the Measures, the CSRC switches back to the phrase "reach 5%" rather than "reach or exceed 5%":

> After the shares whose entitlements are held by an investor and its concerted parties reach 5% of the issued shares of a listed company, if the proportion of the shares whose entitlements are held by them to the issued shares of the listed company increases or reduces by 5% each time, they shall perform the obligations of reporting and announcement according to the preceding Paragraph.[27]

A literal interpretation of this paragraph suggests that a purchaser needs to make a disclosure for every 5% acquisition, similar to the rule described in the open market purchase scenario. This contradicts the language of the first paragraph, which would allow, for example, a one-time purchase of a 20% block with a single disclosure. In practice, the CSRC interprets the second paragraph to mean that a purchaser whose interest reaches *or exceeds* 5% needs to make a disclosure for every additional 5% of the stock of the target company subsequently acquired either through private agreement or in the open market.[28]

Items that should be included in the disclosure are outlined in Article 87 of the Securities Law, which requires a purchaser who triggers the disclosure requirement to disclose its name, address, stock symbol of the shares acquired, quantity, as well as the date when the disclosure requirement was prompted.[29] The CSRC has supplemented this list with a more comprehensive set of requirements in Articles 16 and 17 of the Measures, out of concern that the preexisting list was too general and that more explanatory provisions should be imposed to protect shareholders from unexpected market turbulence.[30] A

[26] Measures for Administration of Takeovers, *supra* note 6, art. 14.

[27] *Id.*

[28] PENG, *supra* note 4, at 269.

[29] Securities Law, *supra* note 15, art. 87.

[30] Measures for Administration of Takeovers, *supra* note 6, arts. 16–17.

purchaser is subjected to Article 16 when acquiring 5 to 20% of a listed company's stock. More importantly, the purchaser may not exert control over the company or the board even if its stockholding is sufficient for it to do so. In addition to the items set forth in Article 87 of the Securities Law, Article 16 requires the purchaser to report the trading history of the stock during the past six months and whether it plans to acquire the control rights of the listed company. Once the purchaser acquires 20 to 30% of the target's shares, Article 17 of the Measures applies. Article 17 imposes additional disclosure requirements, such as conflict of interests with the target and stewardship or restructuring plans that the purchaser has for the target for the following year.[31] If a purchaser fails to satisfy the disclosure requirements, it cannot exercise voting rights associated with the shares it holds or controls until "corrections" are made.[32] Moreover, under the Securities Law, a private party may sue the purchaser for any loss incurred from noncompliance with the disclosure requirements.[33]

2. The Mandatory Bid Rule and Exemption

a. The Mandatory Bid Rule

While many European countries enforce the "mandatory bid" rule, the rule is found in neither federal nor Delaware law in the United States.[34] This divergence stems from differences in capital structures between Europe and the United States.[35] Although China used to adhere strictly to the mandatory bid rule, contradictions between the Securities Law and the Measures and the judiciary's ambivalent stance towards such conflicts have cast doubt on whether the rule still lives in practice.

The Securities Law and the Measures provide two different applications of the mandatory bid rule. Article 96 of the Securities Law states that when a bidder acquires more than 30% of the target company's stock by "agreement or any other arrangement," the bidder shall "issue an offer to all of the shareholders of the target listed company for purchasing all of or part of the company's shares, unless it is exempted from making a tender offer by the securities regulatory authority under the State Council."[36] This allows the

[31] This disclosure requirement applies regardless of whether a buyer has any intent to take control of the target. Measures for Administration of Takeovers, *supra* note 6, art. 17.

[32] *See id.* arts. 75–77. The definition of "correction" is unclear, and there is no official statement on what constitutes correction.

[33] *See* Securities Law, *supra* note 15, art. 69.

[34] REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 252–56 (2009).

[35] *Id.*

[36] Securities Law, *supra* note 15, art. 96.

bidder to decide whether to issue a unanimous or partial offer when it purchases 30% or more shares of a target by either private agreement or open market purchase.

The rule remains the same under the Measures for acquisitions in the open market, but not by private agreement. Under Article 24 of the Measures, when a bidder purchases stock in the open market and its holding reaches 30% of the target's shares, it may also choose to issue a general or partial tender offer.[37] But for a bidder who buys 30% or more of the listed company's shares through private agreement, it must issue a unanimous tender offer for all outstanding shares. As the second paragraph of Article 47 of the Measures states:

> If a purchaser plans to purchase more than 30% of the shares of a listed company by agreement, the part of shares that exceed the said 30% shall be purchased by means of tender offer. . . . [I]f the purchaser fails to obtain the exemption of the CSRC and plans to continue fulfilling the takeover agreement, or fails to apply for exemption, the purchaser shall make a general tender offer before the takeover agreement is fulfilled.[38]

Despite this inconsistency between Article 96 of the Securities Law and Article 47 of the Measures in their treatment of private agreements, market practice follows the Measures given the CSRC's substantial regulatory and enforcement power. Although the judiciary has affirmed the CSRC's deviation in some cases, the judiciary's attitude toward such conflict is still unclear.[39]

b. The Exemption

Pursuant to the Securities Law and the Measures, a purchaser may apply for an exemption from the mandatory bid rule with the CSRC. The exemption increases the flexibility of mandatory bid rule and enhances the CSRC's regulatory and administrative power. At the same time, several criteria must be satisfied for the exemption to apply, which in turn seemingly limits the CSRC's discretion.[40]

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[37] Measures for Administration of Takeovers, *supra* note 6, art. 24.

[38] *Id.* art. 47.

[39] The Chinese judiciary has never ruled in any judgment that the CSRC crossed the line in its treatment of the mandatory bid rule. However, in theory, since the CSRC's regulatory power derives from the Securities Law, it is illegal for the CSRC to deviate from what the Securities Law stipulates and promulgate rules that conflict with the statutory text.

[40] *See* Securities Law, *supra* note 15, art. 96; Measures for Administration of Takeovers, *supra* note 6, arts. 47, 62–64.

Article 96 of the Securities Law grants the CSRC authority to determine when and how to exempt a bidder from the mandatory bid rule.[41] The CSRC has promulgated two types of exemption procedure in the Measures. The first option allows a purchaser to apply for an exemption through a summary procedure under Article 63, with the decision to be made within five days.[42] To qualify for the exemption under Article 63, the purchaser must have acquired the shares without takeover intent.[43] This element can be easily satisfied if the shares are inherited pursuant to inheritance laws or through a merger between SOEs ratified by the SOASAC.[44]

If the bidder is denied exemption under Article 63, a second option is available under the regular procedure of Article 62.[45] Article 62 applies to more complicated situations, some of which could be resolved in a shareholder general meeting to finance a floundering business.[46] The decision of the regular exemption should be rendered within 20 days. However, if the purchaser intends take over the company, it would not qualify for an exemption under Article 62 even if the company is in serious financial difficulties and the purchaser intends to reorganize and finance it.

3. Privatization and Squeeze-out

Under the Securities Law, when a purchaser acquires more than 75% of the target's outstanding shares, the company's stock must be delisted.[47]

[41] Securities Law, *supra* note 15, art. 96.

[42] Measures for Administration of Takeovers, *supra* note 6, art. 63.

[43] *Id.*

[44] Tu, *supra* note 8.

[45] Measures for Administration of Takeovers, *supra* note 6, art. 62.

[46] This include situations where: (1) the purchaser and the transferor can prove that the transfer has not caused the alteration of the actual controller of the listed company; (2) the listed company is confronted with serious financial difficulty, the purchaser has put forward a reorganization scheme for saving the company and obtained the approval of the general assembly of shareholders of the company, and the purchaser promises not to transfer the entitlements it holds in the company within the future three years; or (3) the purchaser obtains the new shares issued to it by the listed company upon the approval of the non-related shareholders of the general assembly of shareholders of the listed company, which makes the shares whose entitlements are held by it in the company exceed 30% of the issued shares of the company, and the purchaser promises not to transfer the shares whose entitlements are held by it within the future three years, and the general assembly of shareholders of the company agrees to the exemption of making a tender offer. It also covers any other circumstance as recognized by the CSRC for adapting to the development and alteration of the securities market or the requirements for protecting the lawful rights and interests of investors. *Id.*

[47] This issue is still controversial. Such divergence is created by different understandings of Article 50 of the Securities Law, which states:

Furthermore, when a listed company goes private, the acquirer must purchase all shares offered by minority shareholders.[48] Nonetheless, the Securities Law does not specify whether—and if so, when—this purchase obligation expires. This places an unnecessary burden on a major shareholder if he must buy back the minority shareholders' shares at any point of time in the future.

The CSRC has attempted to address this problem in the Measures, which have been widely accepted by academia and the judiciary.[49] For example, Article 44 of the Measures states:

> Before the takeover is finished, other shareholders that still hold the shares of the target company have the right to sell their shares to the purchaser under the same conditions as stipulated in the tender offer within the reasonable term as prescribed in the tender offer report, and the purchaser shall purchase the said shares.[50]

This clarifies the ambiguity of Article 97 of the Securities Law, but not completely. For instance, what constitutes a "reasonable term"? Is the term reasonable if the CSRC does not question the validity of the tender offer report

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> A joint stock limited company that applies for the listing of its stocks shall meet the following requirements: . . . (3) the shares as publicly issued shall reach more than 25% of the total amount of corporate shares; where the total amount of capital stock of a company exceeds RMB 0.4 billion yuan, the shares as publicly issued shall be no less than 10% thereof.

Securities Law, *supra* note 15, art. 50. Some believe the wording "publicly" means being held by multiple shareholders on an exchange, while others argue that it does not have such meaning. However, the CSRC and the exchanges have adhered to the first interpretation and take the position that if one purchases more than 75% of the outstanding shares of a listed company, it should be delisted. *See id.* arts. 50, 56. *See also* PENG, *supra* note 4, at 284.

[48] Article 97 states:

> Upon the expiration of a term for acquisition, where the share distribution of a target company fails to meet the requirements of listing, the listing of stocks of the said listed company shall be terminated by the stock exchange according to law. The shareholders that still hold the shares of the target company have the right to sell their shares in light of the equal terms as stipulated in the relevant tender offer, and the purchaser shall make the purchase. When an acquisition is concluded, if a target company fails to meet the requirements for remaining a joint stock limited company any more, its form of enterprise shall be altered according to law.

Securities Law, *supra* note 15, art. 97.

[49] PENG, *supra* note 4, at 284.

[50] Measures for Administration of Takeovers, *supra* note 6, art. 44.

during the disclosure period? Without further official explanation, these issues remain unresolved.

As short form mergers are not permitted in Chinese law,[51] a purchaser who wants to merge with a target after acquiring over 75% of the target's shares must organize a shareholder meeting for the target's shareholders to vote on the merger. Although the purchaser is guaranteed to win by virtue of its majority stock ownership, minority shareholders who vote against the merger still have the right to sell their shares to the purchaser at a "reasonable price."[52] Such minority shareholders may thereby challenge the "squeeze-out" price through litigation.[53] If they lose their claim but continue to refuse to sell at the squeeze-out price, their only option would be to trade their existing shares for those of the surviving company.[54] However, the law does not provide any guidance regarding the exchange ratio or non-public trade shares valuation methods for this type of transaction.

B. Takeover Fiduciary Duty and Private Enforcement

The concept of fiduciary duty was adapted from Western systems to Chinese business laws in 2005, during a comprehensive revision of the business laws by the legislature.[55] The concept has since been implemented in corporate law, takeover regulations, the Securities Law, and the Bankruptcy Law.[56] Moreover, the incorporation of derivative suits into the 2005 Company Law has sent a clear signal to shareholders that shareholders may now sue directors and managers of listed companies for sloppy or self-interested decisions, even when damage caused by such decisions only affected the firm as an entity but not the shareholders directly.[57]

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[51] In Delaware, a "short form merger" allows a parent company holding more than 90% of a subsidiary to unilaterally merge the subsidiary into itself without a shareholder meeting of the transferring company. *See* KRAAKMAN, *supra* note 34, at 203-4.

[52] *See* Company Law, *supra* note 20, art. 75.

[53] *Id.*

[54] *See* Securities Law, *supra* note 15, art. 99 ("When an acquisition is concluded, if the purchaser merges with the target company by dissolving the target company, the original shares of the dissolved company shall be exchanged by the purchaser according to law.").

[55] Weng, *supra* note 19 (discussing transplantation of corporate fiduciary duty). *See also* Charlie Xiao-chuan Weng, *To Be, Rather Than to Seem: Analysis of Trustee Fiduciary Duty in Reorganization and Its Implications on the New Chinese Bankruptcy Law*, 45 INT'L LAWYER 647 (2011).

[56] *See supra* note 20 and accompanying text.

[57] *See* Company Law, *supra* note 20, art. 152.

1. Takeover Fiduciary Duty

Takeover fiduciary duty is an agglomeration of multiple fiduciary duties in business laws.[58] As takeover fiduciary duty's *sine qua non*, Article 148 of the Company Law outlines the general fiduciary liability of directors and mangers.[59] It states: "The directors, supervisors and senior managers shall comply with the laws, administrative regulations, and bylaws. They shall bear the obligations of fidelity and diligence to the company . . . ."[60]

The Company Law by itself does not seem to limit the board's antitakeover tactics. Nevertheless, Article 8 of the Measures requires directors, supervisors, and senior managers of a target company to assume the obligation of fidelity and diligence, and "equally treat" all the potential purchasers that intend to take over the company.[61] The Article explains what "equally treat" means in terms of reining the board's discretionary power to resist takeovers:

> The decisions made and the measures taken by the board of directors of a target company for the takeover shall be good for maintaining the rights of the company and its shareholders, and shall not set any improper obstacle to the takeover by misusing its authorities, nor may it provide any means of financial aid to the purchaser by making use of the sources of the target company or damage the lawful rights and interests of the target company or its shareholders.[62]

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[58] The Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) held that the board of directors had wide latitude to take effective measures that protect their firms from being taken over. The court upheld the legality of employing a self-tender that discriminated against the bidder. Moreover, the court concluded that a board should respond reasonably to any threat posed, but may not take steps that are "draconian" in defending against a takeover. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985), the court held that once the board decides to sell the company, the director's duty will shift to pursuing "the highest price for the benefit of the stockholders." *Id.* at 182. The later decisions in the mid-1990s, *Paramount Commc'n Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994) and *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995), changed the "defensive" business judgment rule from a formal, rhetoric instruction into a substantive standard of review.

[59] Company Law, *supra* note 20, art. 148.

[60] *Id.* There is no official English version of the Company Law, although many unofficial versions exist. In Chinese, the duty of loyalty is same as the duty of fidelity and is called "忠实义务" (*zhongshi yiwu*). While there are numerous Chinese translations of duty of care, the one picked by the legislature roughly translates into "duty of diligence" (勤勉义务) (*qimian yiwu*). There is little evidence that the adaptation of *qimian yiwu* was anything more than an arbitrary selection among many translations or that it indicates any conscious legislative intent to deviate from the western understanding of duty of care.

[61] Measures for Administration of Takeovers, *supra* note 6, art. 8.

[62] *Id.*

Ostensibly, the board or senior executives can neither favor one bidder over another by financing the favorable one, nor expel one bidder by initiating antitakeover actions that put interests of management over those of shareholders. Yet it is still unclear whether ex ante antitakeover actions, such as management-initiated inclusion of a staggered board or an auto-activated right plan in the company's articles of association, are permitted under the current laws.[63]

Aside from management, the Securities Law and the Measures also govern other essential gatekeepers such as consultants.[64] Both impose fiduciary duties on these gatekeepers.[65] Specifically, the Securities Law stipulates that if the gatekeepers violate fiduciary duties, they shall bear joint and several liability together with the listed company.[66] It does not, however, clarify who is eligible to sue the gatekeepers. In practice, fiduciary duty litigation against gatekeepers is rare because of this uncertainty.[67]

2. Private Enforcement

Once fiduciary duty framework has been laid down, the remaining issue is how the legal system facilitates private enforcement of these duties. In most cases, a breach of fiduciary duty may cause damage to the firm as a whole. If shareholders want to sue for the company's loss, they should be authorized to bring a derivative lawsuit on behalf of the firm against the board or senior executives. Article 152 of the Company Law grants shareholders this cause of action.[68] It stipulates that if the board or senior executives breach their fiduciary duty, shareholders who reach a specified holding threshold can sue the management after first resorting to internal remedies.[69] Situations

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[63] Wu Jian (伍坚), Xianzhi Dongshi Gaiixuan Shuliang: Jiaocuo Dongshihui de Zhongguo Moshi (限制董事改选数量：交错董事会的中国模式) [*Limiting the Number of Board Positions in Reelections: Chinese Mode of Staggered Boards*], Zhengquan Shichang Daobao (证券市场导报) [SEC. MARKET HERALD], no. 6, 2007, at 13.

[64] Gatekeepers are reputational intermediaries who provide verification and certification services to investors, who cannot easily perform the same for themselves. John C. Coffee, Jr., *What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis*, 9 J. CORP. L. STUD. 1 (2009).

[65] *See* Measures for Administration of Takeovers, *supra* note 6, art. 9; Securities Law, *supra* note 15, art. 173.

[66] *See* Securities Law, *supra* note 15, art. 173.

[67] Liu Yongming (柳永明), Meiguo dui Xinyong Pingji Jigou de Jianguan: Zhenglun yu Qishi (美国对信用评级机构的监管：争论与启示) [*Supervision of Credit Rating Agencies in the U.S.: Arguments and Lessons*], Shanghai Jinrong (上海金融) [SHANGHAI FIN.], no. 12, 2007, at 57, 60–61.

[68] Company Law, *supra* note 20, art. 152.

[69] *Id.* ("[T]he shareholder(s) of the limited liability company or joint stock limited company separately or aggregately holding 1% or more of the total shares of the

considered as signs that internal remedies have been exhausted include: (1) rejection of a written request by the board of supervisors to initiate a lawsuit against board or senior executives or failure to sue within thirty days of receiving the request; (2) rejection of a written request by the board of directors to initiate a lawsuit against board of supervisor executives or failure to sue within thirty days of receiving the request; or (3) possible irreparable damage if shareholders are prevented from filing the derivative suit.[70] In effect, Article 152 suggests that the board and senior executives cannot avoid litigation if shareholders insist on suing them.

But despite the availability of derivative lawsuits, they have not been effective in enforcing a rigorous fiduciary duty standard. One explanation is the Measures' failure to reinforce informed business decisions. In the United States, *Smith v. Van Gorkom*[71] and similar judicial precedents have applied the business judgment rule to shield directors from liability if the board's decision is an informed one.[72] Outsourcing is the most common judicially recognized way in which a board can demonstrate informed decision-making. In contrast, similar requirements are yet to develop fully in China.[73] While the Measures require a purchaser to hire outside financial consultants for opinions[74] and a bidder to seek legal consultation before applying for the mandatory bid exemption,[75] obligations imposed on target companies are very lax: targets only need to hire outside financial consultants to issue opinions as a reference, which must be presented to the CSRC within 20 days after submitting the purchaser's disclosure report.[76]

The informed decision requirement has been invoked during adjudications by the Chinese judiciary.[77] For this reason, it would be interesting to look back at the CSRC's legislative form to better understand the

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company for 180 consecutive days or more may request in writing the board of supervisors or the supervisor of the limited liability company with no board of supervisors to initiate a lawsuit in the people's court. If the supervisor is under the circumstance as mentioned in Article 150 of this Law, the aforesaid shareholder(s) may request in writing the board of directors or the acting director of the limited liability company with no board of directors to lodge an action in the people's court.").

[70] *Id.*

[71] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[72] Weng, *supra* note 19, at 129 (explaining the business judgment rule and conditions for its application).

[73] *See, e.g., Van Gorkom*, 488 A.2d at 858.

[74] The opinions are to be included in the purchaser's disclosure report, an ad hoc disclosure letter that the purchaser must prepare upon certain triggering events, such as the acquisition of 5% of a company's outstanding shares. Measures for Administration of Takeovers, *supra* note 6, arts. 17, 28, 48, 51.

[75] *Id.* art. 64.

[76] *Id.* art. 32.

[77] Interview with anonymous judge, Shanghai First Intermediary Ct. (June 22, 2011).

informed decision requirement. The judiciary only started to consider applying the business judgment rule when the derivative suit mechanism was incorporated into the Company Law in 2005.[78] Although the judiciary now uses the business judgment rule with greater frequency and sophistication in derivative lawsuit adjudications than it had several years ago, the rule has not yet been established in *lex scripta*.[79] Intuitively, the legislative intent behind making outsourcing requirements for bidders and target companies is not, at least not solely, to protect shareholders from uninformed managerial decisions.

II. THE CSRC'S ROLE IN TAKEOVER SUPERVISION

The CSRC plays a crucial role in governing takeovers, as the Securities Law mandates the CSRC's regulatory power. Analyzing the role of the CSRC in market supervision is therefore helpful in explaining and understanding the CSRC's current takeover regulations. After all, given that China is a highly centralized and bureaucratic country, one cannot ignore the influence of the market regulator when researching its laws. Its source of power and philosophy are therefore linchpins to the research on the current takeover legal system.

A. The Mandate

Unlike in the case of U.S. capital market regulation, Chinese capital market supervisory agencies were not created as a response to a national financial catastrophe.[80] The CSRC was established as a semi-government agency to implement the decrees of the State Council Securities Committee (SCSC) in October 1992, two years after nationwide exchange markets, such as the SSE and SZSE, were set up.[81] Because the first Chinese securities laws were not promulgated until 1998,[82] the CSRC had to rely solely on administrative

[78] Luo Peixin, Li Jian & Zhao Yingjie (罗培新, 李剑 & 赵颖洁), Woguo Gongsi Gaoguan Qinmian Yiwu zhi Sifa Cailiang de Shizheng Fenxi (我国公司高管勤勉义务之司法裁量的实证分析) [*Empirical Research on Duty of Care Adjudications in China*], Zhengquan Fayuan (证券法苑) [SEC. L.F.], no. 3, 2010, at 372.

[79] *Id.*

[80] Walter Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755, 758 (1984).

[81] *Brief Review of the Development of China's Capital Markets*, CHINA SEC. REGULATORY COMM'N, http://www.csrc.gov.cn/pub/newsite/yjzx/cbwxz/ebook/ChinaCapitalMarketsDevelopmentReport.pdf (last visited June 12, 2012).

[82] Zhengquan Fa (证券法) [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999), 6 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 596 [hereinafter Securities Law (1998)], *available at* http://www.lawinfochina.com/display.aspx?id=1084&lib=law.

power derived from the SCSC to regulate and operate the market during the first six years of its existence. The 1997 Asian financial crisis forced the State Council to seriously consider legally and professionally regulating the market, leading to the enactment of the first Chinese securities law. It was in the same year that the State Council abolished the SCSC and incorporated it into the CSRC.[83]

The development of securities industry associations and exchanges has followed a path similar to that of the CSRC.[84] Strong administrative influence continues to shape these associations and exchanges today.[85] Some commentators even think that they are merely puppets of the CSRC.[86] Unlike their U.S. counterparts, which are established through private contracts such as the Buttonwood Agreement,[87] these associations and exchanges are set up and organized by administrative orders to facilitate the CSRC's workings. Thus, in practice, almost no dispute exists between the CSRC and these agencies.

The CSRC's authority does not have a direct statutory basis, but instead derives from the State Council. Both the 1998 and 2005 versions of the Securities Law grant a supervisory agency, as designated by the State Council, market supervisory and regulatory powers.[88] This presumably justifies the CSRC's existence and authority. Nevertheless, one must note that the laws do not explicitly point out which institution is the said supervisory agency. In fact, the State Council is the de facto supervisory body, while the CSRC is only a body created under the State Council's authority. Therefore, it appears that the State Council can abolish the CSRC anytime and install another agency if it wishes. Another sign of this institutional entrenchment is that almost every chairman of the CSRC, before or after his tenure, has become the chief or vice

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[83] *See Brief Review of the Development of China's Capital Markets*, *supra* note 81.

[84] *Id.*

[85] Kang Yaokun (康耀坤), Zhengjianhui yu Zhengquanye Xiehui Quanli Peizhi Yanjiu (证监会与证券业协会权利配置研究) [*Research on the Allocation of Power Between the CSRC and Securities Association of China*], Gansu Shehui Kexue (甘肃社会科学) [GANSU SOC. SCI.], no. 6, 2010, at 186. The stewardship of the exchanges and the Securities Association is firmly controlled by the CSRC. Senior executives of the exchanges maintain ambiguous relationships with the government, and most of the CSRC officials serve in the government before or after their appointment to the CSRC. The associations are similarly situated. The CSRC has power to appoint one fifth of non-dealer members and has other finance rights in the Securities Association.

[86] *Id. See also* Zhang Hui (张辉), Jianguan Zhengjianhui de Nanti (监管证监会的难题) [*The Dilemma of Supervising the CSRC*], Liaowang (瞭望) [OUTLOOK], no. 44, 2009, at 52.

[87] *See, e.g.*, Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, U. ILL. L. REV. 315, 316–21 (1985) (discussing formation of the NYSE).

[88] *See* Securities Law, *supra* note 15, art. 110.

chief of the central bank of China, another governed body of the State Council.[89]

It is therefore not surprising that there is a significant difference between the principal tasks of the CSRC and the Securities Exchange Commission (SEC). The SEC's principal task, established by federal securities laws, is to protect investors.[90] By contrast, the CSRC's goal is to faithfully execute orders from the State Council. This crucial difference frames the CSRC's unique regulatory philosophy. Understanding its government-oriented philosophy is an integral part of the takeover regulation analysis.

B. The Philosophy of the CSRC

Although the CSRC has recently begun to focus on protecting shareholder rights, it is more appropriate to interpret this change as a reflection of policy change by the State Council rather than the CSRC. In recent years, the central government has become increasingly concerned about social stability, integrity, and its public image. The ongoing political discourse on maintaining a "harmonious society" (和谐社会) *(hexie shehui)* implies that it is in the government's best interests to avoid confrontations with stockholders aggrieved by unscrupulous company directors and sluggish government regulators.[91] The State Council has identified the protection of minority shareholders, deemed a socially vulnerable group, as a key to social stability and protection of state assets.[92] Accordingly, the CSRC has shifted away from protecting state-owned assets and stimulating macro-economic growth to protecting shareholder rights. Moreover, a framework for protecting state assets has already been established through a strong supervision system. To a great extent, the CSRC aligns itself very closely with the State Council's policy.[93]

This government-orientated philosophy of the CSRC is also evident in takeover regulations. For example, as discussed in Part I.A.1, the CSRC has imposed disclosure requirements on purchasers reaching a 5% ownership threshold.[94] This requirement is not a mere copy from western countries. In

[89] The only exception is the second CSRC chairman, Zhou Daojiong. He was a high-ranking official in the Ministry of Finance and the chairman of the supervisory board of China Construction Bank, one of the largest state-owned banks in China.

[90] *See* Werner, *supra* note 80, at 756.

[91] *See* Fan, *supra* note 12.

[92] Shang Fulin, Chairman, CSRC, Address at the Seventh Session of China International Forum on Securities Investment Fund (Dec. 2, 2008, 9:12 AM), *available at* http://finance.sina.com.cn/hy/20081202/09125578555.shtml.

[93] *See* Lu Wendao (卢文道), Falü Beihou de Zhengjianhui (法律背后的证监会) [*The CSRC Behind Law*], Caijing Zhengfa Zixun (财经政法资讯) [FIN. & L. INFO.], no. 2, 2010, at 62.

[94] *See* Securities Law (1998), *supra* note 82, art. 41.

the United States, although there is also a 5% disclosure requirement, the disclosure usually is accompanied by disclosure of whether the purchaser intends to launch a takeover.[95] A purchaser with such intent is then required to disclose future restructuring plans after acquiring controlling rights.[96] In contrast, the Measures do not contemplate a similar distinction in purchaser intent. Given the extensive literature on the 5% rule in other countries, it is unlikely that the CSRC has misunderstood how the rule operates in the United States and other jurisdictions due to language and cultural barriers. It is more likely that the CSRC has purposely omitted such distinction. The indiscriminate application of the disclosure obligations not only deters purchasers who do not have intent to take over the company, but also reduces the price premium for bidders by giving the target board more time to react. This helps the market and the CSRC detect the occurrences of large purchases. In the past decade since it emerged from the planned economy system, China has struggled to improve efficiency in its market economy.[97] Inefficiency stems mainly from the large volume of SOEs that are operated without proper economic analysis and market study. The question of how to best restructure the SOE unitary capital structure—i.e., determining the ownership rights of these assets and their relationship with the government—is still in debate. The CSRC's "uniform disclosure" requirement allows the government more time to devise appropriate responses to potential bidders. This also explains the CSRC's requirement of a two or three-day "window period" after every disclosure. The "window period" seems obsolete for any information disseminating purpose, in light of modern communication technology. But once we recognize that the CSRC's goal is to assist SOEs in responding to potential acquirers, it is apparent that the "window period" is in place to enable listed SOEs to go through the administrative hierarchy and solicit instructions from their superiors.

The exemption from the "mandatory bid" rule is another good example of the CSRC's SOE-friendly approach. Among the enumerated exemptible conditions, SOEs can buy or hold each other's shares without making a unanimous offer, which helps SOEs gain an advantage in the market when all

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[95] 17 C.F.R. §§ 240.13d-1, 13g (2008).

[96] *Id.* § 240.13d.

[97] *See* Arnaldo M. Gonçalves, *China's Swing from a Planned Soviet-Type Economy to an Ingenious Socialist Market Economy: An Account of 50 Years* (Centro Argentino de Estudios Internacionales [Argentine Center of International Studies], Working Paper No. 19, 2006), *available at* http://www.caei.com.ar/es/programas/asia/19.pdf (discussing details of transformation from a planned economy to a market economy in China). "Planned economy" is an economic system in which the government controls the economy. Its most extensive form is referred to as a "command economy," "centrally planned economy," or "command and control economy." Under such a system, "resource prices are in many cases distorted, failing to reflect the real value, as many types of resources are still priced by the state, operating on the inertia of the old planned economy." *Id.* at 31. The central government decides what and how much should be produced.

the other firms need to follow the "mandatory bid" rule.[98] Coincidently, in recent large SOEs' delisting events, the vague language of squeeze-out rule has proven to be very helpful to SOEs.[99]

The CSRC's SOE-friendly approach, which makes the government both a market-player and a referee, has been widely criticized.[100] But given the present political framework and the CSRC's ambivalent legal existence,[101] the independence of the CSRC probably cannot be achieved overnight.[102] Most important of all, the Chinese capital market regulatory regime has become too accustomed—if not addicted—to relying on administrative regulation.[103]

C. Can the CSRC Change Current Takeover Regulations?

Before we evaluate the impact of current takeover regulations on shareholder rights and market efficiency, it is important to address the question of whether the CSRC can change or redefine its regulatory approach. If it does not have the ability to do so, it would be pointless to discuss the issue any further. Fortunately, the answer is yes: the CSRC does have the power to change its approach. As discussed above, the CSRC's working philosophy piggybacks on the State Council's policy. If the State Council's policy changes course, the CSRC's philosophy follows accordingly. For the past three decades of economic reform, the State Council has been restructuring SOEs and capital markets. The current landscape is far different from 1990, when China's first stock exchange was launched. Most SOEs in monopoly industries, such as energy and telecommunications, are now delisting or reducing publicly traded shares from stock markets to maintain more business secrets and solidify state control.[104] In addition, the central and local governments have become more sophisticated in operating state assets and have come to view market

[98] *See* Measures for Administration of Takeovers, *supra* note 6, art. 63.

[99] Li Rongrong (李荣融), Daxing Kunnan Guoqi Lizheng 2008 Nian Quanbu Tuishi (大型困难国企力争 2008 年全部退市) [*Large SOEs Strive to Delist Completely by 2008*], Zhenggong Yanjiu Dongtai (政工研究动态) [RES. ON POL. BUS. REP.], no. 17, 2005, at 1 (discussing the central government's plan of delisting big SOEs).

[100] *See* Lu, *supra* note 93; Zhang, *supra* note 86.

[101] While the CSRC plays the *de-facto* role of a government agency, there in fact is no clear statutory basis for its establishment and operations.

[102] Wang Jianwen (王建文), Zhongguo Zhengjianhui de Zhuti Shuxing yu Zhineng Dingwei: Jiedu yu Fansi (中国证监会的主体属性与职能定位：解读与反思) [*Analysis of the Subject Character and Functional Position of the CSRC*], Faxue Zazhi (法学杂志) [L. SCI. MAG.], no. 12, 2009, at 41. *See also* Lu, *supra* note 93; Kang, *supra* note 85.

[103] Wang, *supra* note 102, at 41.

[104] He Shaoqi (贺绍奇), Tuichu Fangshi Buru Tuichu Gushi (退出房市不如退出股市) [*It Is Better to Withdraw from the Stock Market than from the Real Estate Market*], Jingji Guancha Bao (经济观察报) [ECON. OBSERVER], Apr. 12, 2011 at 43.

competition rather than administrative interference as the promoting force for the competitiveness of SOEs.[105] The state has hence increasingly taken on the role of a gatekeeper rather than an active market player. The widening wealth gap and the need to mediate its relationship with the public have also made the creation of a fair competitive environment a political imperative for the government.

As a recent remark by the Chairman of the CSRC showed, concerns over maintaining a fair market have also been recognized by the CSRC.[106] The CSRC has recently modified regulations to include more reasonable and fairer game rules, such as removing the mandatory bid rule exemption for listed SOEs.[107] If the existing rules are inefficient and unfair and cannot maximize value for shareholders as a whole, it is in the interest of the CSRC to promptly revise them.

III. MARKET IMPACT OF CURRENT TAKEOVER REGULATIONS

A. Does Management Consider More for Stakeholders?

The *sine qua non* of maximizing shareholder value in takeovers is that senior management, in evaluating the takeover deal, consider shareholders' interests loyally and responsibly instead of their own. In practice, however, very few mechanisms can ensure this. In control transactions, ordinary corporate governance measures such as stock options are no longer effective in aligning management's interests with those of the shareholders, as the one-time transaction may terminate the management's employment and render post-takeover incentives insignificant. Ad hoc means purporting to alleviate agency problems in takeovers, such as golden parachutes, have also proven to be problematic.[108]

When the "carrot policy" is not effective, the "stick policy" becomes the last straw that shareholders can count on. The imposition of fiduciary duties on senior management is crucial for ensuring its loyalty. But while the Chinese legislature has introduced this principle on the books, its enforcement in practice is far from satisfactory. From 2008 to 2010, there have only been fifteen cases litigated at Shanghai Pudong District Court on the issue of

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[105] Sunjian (孙坚), Jiashu Guoqi Binggou Congzu Shichanghua (加速国企并购重组市场化) [*Ways of Expediting the Marketization of SOEs*], Dongshihui (董事会) [DIRECTORS & BOARDS], no. 65, 2009, at 63.

[106] Shang, *supra* note 92.

[107] *See* Measures for Administration of Takeovers, *supra* note 6, art. 63.

[108] *See, e.g.*, Kenneth C. Johnson, *Golden Parachutes and the Business Judgment Rule: Towards a Proper Standard of Review*, 94 YALE L.J. 909 (1985). Proponents of golden parachutes argue that they help an executive to remain objective during the takeover process, while opponents believe that golden parachute costs are a very small percentage of takeover costs and do not affect the outcome.

fiduciary duty.[109] Moreover, only two of them were derivative actions. Considering that the total number of registered corporations in the district exceeds 110,000, [110] the number of fiduciary actions is miniscule. Understandably, Chinese senior executives are far less concerned about the threat of derivative litigation than their U.S. counterparts.

Multiple factors contribute to the ineffectiveness of fiduciary duties as a way to assure management loyalty. First, regulation of ex ante antitakeover mechanisms is still inadequate. As mentioned in Part I.B.1, the Measures only address ex post violations but not ex ante preventive measures.[111] Chinese corporate and securities laws also do not consider the legitimacy of ex ante antitakeover mechanisms such as poison pills or staggered boards. Moreover, even though the power to amend the articles of association lies in the hands of shareholders, [112] the board enjoys unilateral control over the flow of information both within the firm and to shareholders. Not only are there no regulations requiring the board to implement mechanisms to assist shareholders in making informed decisions,[113] there are also no independent consultant institutions similar to Institutional Shareholder Services to educate shareholders about the downside of defense mechanisms such as staggered boards.[114] Thus, a board can easily manipulate the outcomes of general meetings and incorporate powerful antitakeover mechanisms such as poison pills[115] or a staggered board into the articles of association, without fearing fiduciary duty challenges.[116] It has little to fear when it comes to proxy contests by bidders to change the articles of association and redeem the pill. Not only does the board control the information flow, but the bidder must also win two-thirds of all outstanding votes to prevail in the contest.[117] Moreover, the

[109] Interview with anonymous judge, *supra* note 77.

[110] Interview with anonymous officer, Shanghai Pudong Admin. for Indus. & Commerce (July 28, 2011).

[111] *See supra* text accompanying notes 57–59.

[112] *See* Company Law, *supra* note 20, art. 44.

[113] A "staggered board" is a board in which only a fraction of the members of the board of directors is elected each year instead of en masse.

[114] Empirical evidence has indicated that shareholders in the United States have sometimes disfavored staggered boards. *See, e.g.*, Jason D. Montgomery, *Classified Boards*, CORP. GOVERNANCE SERV., Mar. 3, 1998, at 1; *Record Support for Destaggered Boards Highlights Shareholder Proposal Results*, CORP. GOVERNANCE HIGHLIGHTS, June 18, 1998, at 97 (demonstrating increase in shareholder proposals demanding de-staggering of staggered boards in the United States).

[115] "Poison pills" or a "rights plan" is a strategy to discourage hostile takeovers by issuing new shares at a nominal price to all shareholders except the bidder.

[116] This strategy makes poison pills more powerful, because it would be impossible to modify the bylaw by changing directors in a short time to remove the poison pills.

[117] *See* Company Law, *supra* note 20, art. 44.

legitimacy of proxy contests is still controversial in China.[118] If the law does not impose a comprehensive fiduciary duty regulating both ex post and ex ante improper defense actions, board directors can freely choose preventive measures to insulate themselves from takeovers.

Second, the efficacy of the fiduciary duty requirement has been greatly dampened by the limitations of *lex scripta* and sloppily drafted rules. Fiduciary duties are highly context-specific, and their nature and extent can vary widely across different situations. Therefore, it is impossible for the Chinese legislature to exhaust all possible application scenarios in the statutes.[119] This leaves numerous gaps left for judges to fill, which in turn creates inefficiency and risks of corruption within the judiciary.[120] And although China's achievements in legal reform have been stunning in the past decades,[121] the capabilities of the judiciary in economically developed and developing areas are still asymmetric.[122]

Another area that suffers from poor drafting, as discussed earlier, is the outsourcing requirement. Although one provision in the Measures requires the board of a target to seek opinions from outside consultants, it does not specify the legal consequences of failing to do so and the connection to the fiduciary duty rule.[123] Admittedly, the judiciary has already incorporated the outsourcing requirement into fiduciary duty adjudication and ruled that failure to meet this requirement may render the business judgment rule inapplicable such that senior executives cannot shield themselves from judicial scrutiny.[124] However, such practice has no direct support from Chinese law and can only be explained as a result of the influence of American practice in China.

Third, the requirement that shareholders must exhaust internal remedies before bringing a derivative lawsuit further discourages private enforcement by imposing an unnecessary burden on shareholders. Under the Company

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[118] Chen Yunying (陈云英), Lun Gudong Biaojuquan Zhengji Zhidu de Wanshan (论股东表决权征集制度的完善) [*A Discussion on Improving Shareholder Proxy Contests*], Shangchang Xiandaihua (商场现代化) [MARKET MODERNIZATION], no. 495, 2007, at 284.

[119] *See* Weng, *supra* note 55.

[120] *See* Weng, *supra* note 19, at 142.

[121] Xia Jinwen (夏锦文), Dangdai Zhongguo Sifa Gaige: Chengjiu, Wenti yu Chulu—Yi Renmin Fayuan wei Zhongxin de Fenxi (当代中国司法改革：成就，问题与出路—以人民法院为中心的分析) [*Legal Reform in Contemporary China: Achievements, Problems and Solutions—An Analysis Based on the People's Court*], Zhongguo Faxue (中国法学) [CHINA LEGAL SCI.], no. 1, 2010, at 17.

[122] Xiao Yang (肖扬), Zhongguo Sifa Gaige de Chengji yu Fazhan Qushi (中国司法改革的成绩与发展趋势) [*Achievements and Developing Trends in Chinese Legal Reform*], Renmin Sifa (人民司法) [PEOPLE'S JUDICATURE], no. 13, 2007, at 4. *See also* Xia, *supra* note 121.

[123] *See* Measures for Administration of Takeovers, *supra* note 6, art. 31.

[124] Interview with anonymous chief director of the financial adjudication court, Shanghai First Intermediate Ct. (Mar. 3, 2010).

Law, shareholders must demand that the board of directors or board of supervisors address their claim before proceeding to courts themselves.[125] This demand requirement mirrors the prevailing rule in the United States, where many states also require shareholders who want to bring a derivative suit to first make a demand on the board, unless demand would be futile.[126] On its face, the Chinese rule appears more shareholder-friendly than its American counterpart. Whereas shareholders may not bring a derivative action under the American rule if the corporation validly rejects the shareholders' demand, shareholders can bring a derivative lawsuit under the Chinese rule regardless of the company's response thirty days after the board's receipt of their demand.[127] But despite initial appearances, the Chinese rule is actually management-friendly. In the United States, many states permit corporations to appoint an independent and disinterested committee of directors to evaluate the shareholders' demand and decide whether the suit should be pursued. In reviewing such conclusion, courts often afford the committee the protection of the business judgment rule and terminate the action before trial if the decision is a well-informed one. In China, however, the business judgment rule has not been recognized and is still developing in practice. The uncertainty in the rule's application disincentivizes executives from adopting procedures that would make the internal remedy requirement meaningful. Since establishing an independent committee does not necessarily trigger the business judgment rule, directors find no reasons to adopt this practice. Instead, the board would rather judge the claims on its own, and very few cases ever receive support from the company. The demand requirement under the Company Law is therefore reduced to a mere procedural requirement that gives the board a thirty-day notice to prepare for the impending lawsuit. Most shareholders are also not interested in fiduciary duty litigation in takeover matters since they always need to pay for litigation expenses on their own beforehand.

B. Shareholder-friendly or Takeover-friendly?

Given that the private enforcement scheme is not an effective way to protect shareholder interests, takeover regulations become crucial tools to warn shareholders in advance and block self-interested transactions. It is barely news that in the past twenty years, unscrupulous CEOs and voracious bidders have taken advantage of the takeover business opportunity to benefit themselves at shareholders' expense.[128] As such, some believe that the current

[125] *See* Company Law, *supra* note 20, art. 152.

[126] Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: the ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1349 (1994). *See also* Note, *Extortionate Corporate Litigation: the Strike Suit*, 34 COLUM. L. REV. 1308 (1934).

[127] *See* Company Law, *supra* note 20, art. 152.

[128] Chun, *supra* note 4.

Chinese takeover regulations best serve shareholders' interests because of its chilling effect on takeovers.[129] This approach, however, ignores the value-maximizing potential of takeovers. As Professor Romano noted about American takeover laws, "[i]nfluenced by unsubstantiated fears and suspicions, often raised by managers, about the impact of takeovers on third parties, regulation in the United States has tended to thwart and burden takeovers as if they were non-value-maximizing wealth transfers."[130] This description is a meaningful characterization of Chinese takeover regulations as well, even if the underlying legislative motive may vary between the two countries. The Chinese legislature and the CSRC have designed regulations so strict that they have suffocated most potential takeover deals and extinguished opportunities to maximize shareholder value as a whole.[131] Meanwhile, laws and regulations do not protect shareholders from agency problems. Senior executives of SOEs have thus emerged as the final winners in the contest between shareholder-friendly and takeover-friendly approaches.

Take the current disclosure regime as an example. Almost every takeover law in the world has a disclosure requirement to ensure that the target's shareholders and management are fully informed to weigh the cost and benefit of the proposed deal. Disclosure is also an effective way to alleviate the information asymmetry problem: availability of up-to-date, accurate, and relevant information can help shareholders of listed companies assess agency problems.[132] Yet, disclosure may also decrease the profitability of the takeover endeavor by prematurely informing the market that the target firm is undervalued, thereby attracting the market to rush in and inflate the stock price of the target company.

The divergence among different jurisdictions regarding disclosure reflects varying degrees of balancing of the protection of target shareholders and the legitimate profit pursuit of bidders. Judging from the Chinese disclosure requirements, it is hard to see which set of interests the government leans towards. From the perspective of shareholder protection, it is meaningless to inform the management and shareholders that there is someone acquiring the listed firm's shares without revealing the buyer's purpose. The shareholders and management would not take actions to defend against or encourage the bidder solely based on the acquisition. But in the private purchase scenario, the "5% rule" fails to give timely information of the buyer's intent. As discussed in Part I.A.1, the Measures allow a purchaser to make an acquisition as large as 20% before making its first disclosure.[133] By the time the board and other shareholders learn of a bidder's intent to take over the company, the bidder has already acquired a substantial percentage of the company's outstanding stock. In some cases—especially for companies with dispersed

[129] *See, e.g.*, Zhang & Li, *supra* note 7, at 77; *see also, e.g.*, Ma, *supra* note 7, at 9.

[130] Romano, *supra* note 1, at 120.

[131] PENG, *supra* note 4, at 286. *See also* Chun, *supra* note 4.

[132] KRAAKMAN, *supra* note 34, at 248.

[133] *See* Measures for Administration of Takeovers, *supra* note 6, art. 16.

share ownership, such as publicly-traded companies—even a 15 to 20% ownership is enough for a new shareholder to reap a control premium.

Whereas the disclosure rules in the private sale scenario disadvantage shareholders by failing to supply timely information, the rules for public market acquisitions deter bidders by requiring too many disclosures. If a bidder chooses to take over a firm by purchasing stock in the open market, the disclosure obligation forces the bidder to stop six times before he acquires a 20% interest and pause for a total of thirteen days before the bidder's block can reach 30%.[134] Every stop and disclosure is effectively a broadcast to the market of the buyer's interest in the target. With each pause, the price of the target goes up. The excessive disclosure thus eliminates almost all the premium that the bidder would have attained under less frequent disclosure requirements. Worst of all, the prolonged disclosure and waiting period opens the window for more competitors to pursue the target and effectively transform the takeover action into an auction. While auction in some cases is a helpful mechanism to maximize shareholders' value, a unanimous auction can increase takeover costs excessively and make the takeover unattractive.[135]

What can be the motivations underlying these disclosure requirements? In addition to attracting more competing bids to increase existing shareholders' leverage, one possible justification for the frequent and prolonged disclosure requirement may be a desire for meaningful information dissemination. Disclosure requirements in the takeover context are generally premised on the view that information disclosure is ineffective unless shareholders are given sufficient time to absorb the information before they have to act on it.[136] But with the development of modern technology, information can be disseminated within seconds. In the contemporary business world, once valuable information is exhaustively disseminated, information disclosures, including unsubstantiated rumors, can be influential even if they are inaccurate.[137] To that end, it seems unnecessary to demand so many window periods. Instead, the CSRC's SOE-friendly approach is a more likely reason for the disclosure rules. As discussed in Part II.B, reform of SOEs has been the key task in the past. Prompted by a fear of losing state-owned assets (SOAs), the central government is determined to scrutinize as many transactions involving SOAs as possible. Both the Measures' disclosure and outsourcing requirements cater to this desire for greater scrutiny. The CSRC's frequent and prolonged disclosure requirements, with their multiple stop periods, provide the SOASAC with time to review transactions and complete all bureaucratic

[134] Disclosure is followed by a two-day window period except for the first disclosure, which is followed by a three-day window period. *See supra* note 24 and accompanying text.

[135] Romano, *supra* note 1, at 161–69.

[136] KRAAKMAN, *supra* note 34, at 250.

[137] Jeffery N. Gordon & Lewis A. Kornhauser, *Efficient Market, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 765–76 (1985).

procedures. Furthermore, the outsourcing requirements enable the SOASAC and the CSRC to have professional reviews of the transactions.[138]

Similarly, the mandatory bid rule is also purported to protect shareholders' interests[139] but may have instead worked to their detriment. The rule is imported from western countries, particularly from Britain. Its primary function is to prevent acquirers from making coercive bids.[140] It protects minority shareholders by ensuring that all shareholders have the opportunity to tap into a share of the control premium.[141] But this rule, contrary to the beliefs of many, is not indisputably shareholder-friendly.[142] As Reinier Kraakman has pointed out, "[a] system which rigorously controls defensive tactics on the part of management may nevertheless still chill takeover, say, strict insistence upon equality of treatment of the target shareholders by the acquirer or the prohibition of partial bids."[143] The chilling effect of the mandatory bid rule is obvious in the Chinese capital market. Private firms usually find it very difficult to obtain takeover capital from financial institutions.[144] Because leveraging and borrowing between private firms are illegal,[145] they need a sizable and self-owned capital to finance takeovers. This financing burden is further heightened by the mandatory bid rule's requirement that a bidder buy all the shares tendered to the bidder. This not only hinders Chinese private firms from planning a takeover but also lowers the rewards of a takeover: the bidder must share the control premium with the target's shareholders, leaving the bidder only with synergy gains. Although private firms nowadays can form joint ventures with international

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[138] *See* Measures for Administration of Takeovers, *supra* note 6, art. 9; Securities Law, *supra* note 15, art. 173.

[139] *See* sources cited *supra* note 7.

[140] Armour & Skeel, *supra* note 2, at 1729.

[141] *Id.* at 1738; GARY EABORN, TAKEOVERS: LAW AND PRACTICE 132–33 (Gary Eaborn ed., 2005).

[142] Romano, *supra* note 1, at 119–20; Erik Berglöf & Mike Burkart, *European Takeover Regulation*, 18 ECON. POL'Y 171, 196–98 (2003); D. D. Prentice, *Take-Over Bids and the System of Self-Regulation*, 1 OXFORD J. LEGAL STUD. 406, 409 (1981).

[143] *See* KRAAKMAN, *supra* note 34, at 268.

[144] *See, e.g.*, Chen Zhi (陈植), Binggou Daikuan Minqi Lingpi Xijing (并购贷款民企另辟蹊径) [*Private Firms Looking for New Ways to Finance Takeovers*], Zhongguo Minying Keji yu Jingji (中国民营科技与经济) [CHINA NON-GOVERNMENTAL SCI. TECH. & ECON.], no. 4, 2010, at 72. Financial institutions are more willing to finance SOE projects, because SOEs are usually perceived to be too big to fail. Even when SOEs are on the verge of failing, there is an expectation that the government will bail them out.

[145] Wu Xiaojing (吴晓静), Qiye Jiang Jiekuan Hetong de Xiaoli Wenti (企业间借款合同的效力问题) [*Legality of Finance Contracts Between Private Firms*], Renmin Sifa (人民司法) [PEOPLE'S JUDICATURE], no. 23, 2007, at 27. Whether borrowings between private firms are legal is a controversial problem. It is very likely that courts will consider such borrowings to be illegal.

conglomerates to finance their daily businesses, the strict foreign exchange control policy renders it logistically cumbersome to orchestrate takeovers given the reduced rewards.[146]

Although there is no current Chinese regulation that explicitly permits the squeeze-out of minority shareholders through short-form mergers, a purchaser who acquires over 75% of a target company and subsequently prompts the delisting of the target company is required under current law to purchase all shares offered by minority shareholders.[147] In practice, in a regulatory environment where very few hostile takeovers actually occur, there are few cases in which minority shareholders' aggregate ownership of the target's outstanding shares is reduced to less than 25% to trigger the delisting. Thus, very few bidders actually trigger the sell-out provision by acquiring and delisting firms,[148] and it is difficult to assess the effects of this provision. Ultimately, the Chinese capital market is still experiencing a wave of massive public listing of private firms rather than delisting due to private takeovers. It is rare to find a sell-out case initiated by going-private firm.

C. Efficacy Conclusions

In summary, Chinese takeover laws do not easily fall into the traditional takeover categorization of being shareholder-friendly versus takeover-friendly. Instead, analysis of the practical implications of the takeover mechanisms demonstrates that the CSRC has adopted a SOE-friendly approach due to its legal and political dependence on the central government. Although highly concentrated ownership structures have also been a practical impediment to takeover transactions, the takeover-unfriendly laws have further deterred takeover attempts. Particularly, SOA-related takeovers have encountered especially strict government scrutiny and SOE-friendly takeover laws, all at the expense of shareholders' lost opportunities for value-maximization.

Despite recent Chinese economic reforms, there remains a significant number of SOEs operating at low efficiency levels.[149] The mandatory bid rule

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[146] *See, e.g.*, Zhang Xincun (张新存), Waihui Guanzhi Zhengce dui Guoji Maoyi de Yingxiang ji Woguo Waihui Guanli Zengce de Yanjin (外汇管制政策对国际贸易的影响及我国外汇管理政策的演进) [*The Influence of Foreign Exchange Control Policy on International Trade and the History of Chinese Foreign Currency Policy*], Jingji Luncong (经济论丛) [ECON. FORUM], no. 6, 2006, at 33.

[147] *See supra* note 50 and accompanying text.

[148] *See* Zhang Yifang (张宜芳), Woguo Shangshi Gongsi Tuishi Jizhi de Yanjiu (我国上市公司退市机制的研究) [*A Study on the Delisting Mechanisms for Listed Companies in China*], Zhishi Jingji (知识经济) [KNOWLEDGE ECON.], no. 4, 2009, at 33.

[149] Yue Liang & Lü Shanshan (岳亮 & 吕珊姗), Cong Gaishan Qiye Neikong Rushou Tisheng Guoqi Jingying Xiaolü (从改善企业内控入手提升国企经营效率) [*Improving the Operation Efficiency of SOEs Through Enhancing Internal Control*], Caiwu yu Kuaiji (财务与会计) [FIN. & ACCT.], no. 1, 2010, at 35.

lowers private firms' incentives to launch takeovers, while mergers and stewardships of SOEs remain tightly controlled in the hands of the SOASAC. Leaving SOEs' agency problem unaddressed—and relying on administrative orders of the SOASAC instead of market forces—fosters inefficient operation and self-dealing.[150] With the shifting focus of government policy in recent years, however, the current takeover regime needs a substantial revision toward a more shareholder-friendly direction.

IV. TOWARDS BETTER TAKEOVER LAWS

Despite China's move towards policies that seek to promote a harmonious society, the frequency of mass disturbances has risen rapidly.[151] These disturbances are often fueled by the persistent inability of millions of workers and farmers to access the benefits of China's economic growth. The indifference of the economically advantaged to any discussion of a fair competitive environment further exacerbates this socio-economic divide and pushes the disadvantaged to fight for their fair share.

The call for harmony is also found in the capital market, where stockholders continue to lobby for greater transparency and enforcement of illegal self-dealing cases.[152] Because of the CSRC's SOE-friendly approach, it is not surprising that the Measures, while seemingly shareholder-friendly on the surface, substantially depart from non-governmental shareholders' interests. The current approach not only fails to serve the rapidly developing market but also contradicts the central government's growing emphasis on social stability. As discussed in Part II, the State Council's focus has shifted in recent years from reform of SOEs and protection of SOAs to promotion of a "harmonious society."[153] That the CSRC derives its market regulatory power from the State Council pursuant to the Securities Law requires the CSRC to be responsive to the State Council's policy directions. The significant policy change at the State Council level thus means that the CSRC should also reform its policy from an

[150] While Article 73 of the Securities Law prohibits self-dealing, managers of SOEs in some cases are protected by the central government and insulated from prosecution. The lack of market discipline and shareholder supervision leaves self-interested actions of SOE managers unchecked.

[151] In most cases, the conflicts are invited by unjustified acts of local authorities and triggered by isolated incidents. At the beginning, the incident can be a small-scale conflict between the local authority and victims of the government's acts. Then, other indignant social groups, which probably share the same grievances, join in the conflict. The scale of conflicts, in some cases, has escalated to regional upheaval.

[152] Li Mingzhi (李命志), Zhengquan Fa de Xiugai yu Shangshi Gongsi Shougou Zhidu de Wanshan (证券法的修改与上市公司收购制度的完善) [*Revision of Securities Law and the Improvement of Takeover Rules for Listed Companies*], Zhongguo Jinrong (中国金融) [CHINA FIN.], no. 1, 2006, at 56.

[153] Shang, *supra* note 92.

SOE-friendly approach to one that is more congruent with the State Council's socio-economic vision of a "harmonious society."

One solution is the "social entity conception" framework, which can alleviate the tension among the interests of market supervisory agencies, private investors, and the central government. The social entity conception proposed in this Article is not identical to what was originally conceived by Professor William Allen.[154] The original approach encourages corporations to consider the social wellbeing of all constituencies, including external stakeholders and owners. Under the approach proposed here, companies would adopt governmental interests as its guiding value. Given the current desire to achieve a harmonious society, takeover legislation should consider the social wellbeing of all and not just state stakeholders. With this shift of focus from SOE interests to stakeholder interests, the social entity conception approach can assist the CSRC to comply with the central government's "harmonious society" policies.

Some assume that Chinese corporate law has already long embodied this social entity conception framework.[155] Yet, the analysis of China's takeover regime in the foregoing discussion suggests that this is not the case and that much of the legislation from the past twenty years has adhered to the "partial shareholder primacy" principle. This principle does not maximize shareholders' value as a whole, which is ironic for legislation that is supposed to have a core objective consistent with "the interests of the People."[156] Instead, the interests that these laws have primarily advocated are those of SOEs and the central government. This bias favoring only state shareholders is inconsistent with the policies of the harmonious society. Thus, drafters of Chinese takeover legislation must develop a road map to modify current SOE-friendly regulations into those that improve shareholder welfare as a whole. Laws should treat every market participant equally and alleviate the public's dissatisfaction with market supervisory agencies. Maximizing shareholder wealth in turn promotes fair wealth distribution, a main principle of the harmonious society.

Applying this social entity conception approach, this Part will provide strategies for amending current takeover regulations in a way that would maximize social welfare and foster a fair market system. Specifically, it will suggest changes to disclosure, mandatory bid, and private enforcement regulations.

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[154] Allen, *supra* note 14, at 264–72.

[155] *See, e.g.*, Guo Long (郭龙), Woguo Shangshi Lifa de Shangshi Tongze Moshi Taolun (我国商事立法的商事通则模式讨论) [*A Discussion on the Commercial Principles of Commercial Law Legislation in China*], Lanzhou Daxue Xuebao (兰州大学学报) [LANZHOU U. J.], no. 38, 2010, at 129.

[156] *See* XIANFA art. 1, §§ 1, 2, 5 (1981), *available at* http://www.gov.cn/gongbao/content/2004/content_62714.htm (requiring all laws promulgated to follow the basic principles of socialism and all the rights belonging to the People and all the laws to be enacted in the interests of People).

A. Changes to Takeover Regulations

1. Heightened but Fewer Disclosures

Although current Chinese takeover regulations demand more frequent disclosures than many other regimes, they still fail to achieve the intended objectives of ad hoc disclosure requirements, i.e., helping principals effectively evaluate whether to maintain their ownership after a takeover or exit the firm entirely.[157] The primary cause of this failure is the absence of a requirement for purchasers to disclose takeover intentions, a piece of information that is critical to a principal's decision to exit.[158] At the same time, the law unnecessarily requires disclosure with each 5% change in stockholding.[159] More information alone does not necessarily benefit shareholders.[160] The excess of information deters potential bidders by reducing their anticipated control premium. To maximize all shareholder values and support a fair market, the current disclosure regulations should be modified to eradicate these failings.

First, disclosure rules should be amended to require all purchasers to disclose their intent to acquire control once their stock ownership reaches 5%. To provide sufficient details to shareholders for informed decision-making, the disclosure should include up-to-date, accurate, and relevant information that enables shareholders to better assess agency and coordination problems.[161] In addition, disclosure must be timely for a target company to have sufficient time to prepare its defenses in the event of an undesirable takeover threat.[162] As Professor David Skeel has explained, the main goal of the mandatory disclosure rule is to prevent bidders from conducting so-called "Saturday night special" tender offers that pressure shareholders into tendering their shares without proper consideration by imposing tight time constraints and limiting tender offers to a first-come, first-serve basis.[163] To serve this purpose, disclosure of a bidder's takeover intent at an early ownership threshold is the linchpin of an effective disclosure system. When intent to control is disclosed early on, shareholders have the opportunity to decide whether to tender or keep their shares.[164]

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[157] KRAAKMAN, *supra* note 34, at 49.

[158] *See* Measures for Administration of Takeovers, *supra* note 6, arts. 16–17.

[159] *See supra* Part I.A.1.

[160] Sanford Grossman & Oliver Hart, *Disclosure Laws and Takeover Bids*, 35 J. FIN. 323 (1980).

[161] KRAAKMAN, *supra* note 34, at 248–49.

[162] Armour & Skeel, *supra* note 2, at 1755.

[163] *Id.*

[164] KRAAKMAN, *supra* note 34, at 257–59.

Second, the frequency of disclosure should be reduced. While existing shareholders might benefit from the elimination of coercive bids, they might suffer from over-demanding disclosure requirements that disincentivize cash tender offers.[165] In certain situations, the disclosure requirement may be triggered six times with a thirteen-day window period.[166] These overly frequent disclosures disadvantage bidders and disinterested investors, as well as shareholders. For potential bidders, broadcasting their interest to acquire the target jeopardizes the control premium that they would otherwise capture.[167] For disinterested investors like large institutions, burdensome disclosure requirements unduly expose their investment strategies to the public, who might then mimic their tactics. Each disclosure may then result in a decreasing return to these institutional investors. For the target's shareholders, high transaction costs associated with the excessive disclosure requirement deters takeovers, which in turn leaves managerial inefficiency unchecked and creates an overall negative impact on the capital market.[168] Rather than demanding multiple disclosures, a one-time disclosure at the 5% mark is sufficient to give notice to shareholders of the target company. With the development of rapid information dissemination and consultant services, even the window period may be eliminated as well. In any case, as long as the one-time intent disclosure is in place, the window period is no longer a major issue.

Third, the disclosure mechanism should prompt secondary disclosure when there is a change from non-control to control intent after the first 5% disclosure. Leaving this possibility unregulated lets a purchaser gain control of the target with its control intent undetected. Hence, it is important to set a flipping point, a threshold after which a purchaser may not change its intent from merely purchasing shares to acquiring control. Article 17 of the Measures currently leaves a loophole through which bidders can legally conceal their takeover intent.[169] Under the flipping point rule proposed here, bidders must either disclose their change of intent or bear the cost of non-compliance. For example, if Company A had declared that it had no intent to assume control when it first acquired 5% of Company B's shares and the flipping point were set at 20%, then Company A would not be able to change its position once its stock ownership reaches 20%. For situations where there is no intent to acquire control, using a flipping point is better than requiring multiple

[165] Armour & Skeel, *supra* note 2, at 1755.

[166] *See supra* notes 20–22 and accompanying text.

[167] *See supra* notes 20–22 and accompanying text.

[168] Grossman & Hart, *supra* note 160, at 323.

[169] Article 17 states: "If the shares whose entitlements are held by an investor and its concerted parties reach or exceed 20% but do not exceed 30% of the issued shares of the listed company," the investor shall disclose future reorganization and stewardship plans. This imposes a cap at 30% and presumes that the purchaser has control intent if its ownership exceeds that cap. *See* Measures for Administration of Takeovers, *supra* note 6, art. 17.

disclosures—it avoids the unnecessary repetitive disclosures. And in cases where a purchaser wishes to switch from non-control to control intent, a window period would be triggered to allow the target and the target digest this new information. Considering that Chinese listed companies are generally smaller than their American counterparts, it would be reasonable to limit the change of purchase intent within the range of acquiring 20 to 30% of outstanding shares.[170] While the flipping mechanism proposed here is substantially different from the procedures required by Article 17, it would have a similar percentage ownership cap.[171]

2. An Opt-out Mandatory Bid Rule

According to the Securities Law, the mandatory bid rule may not be waived by shareholder votes. This allows shareholders a share of the control premium that the controlling shareholder receives after selling out and relinquishing control.[172] Notwithstanding this intended purpose, however, some scholarship has doubted whether the shareholders are indeed better off with a mandatory bid rule.[173] First, the rule imposes greater capital requirements on a bidder wishing to acquire control rights.[174] Without the rule, if a bidder intends to acquire a company with a total of 1,000 shares at $1 per share, the bidder will probably need only $501 to accomplish the absolute control transfer. But under the mandatory bid rule, the bidder may need up to $1,000 to acquire control if minority shareholders decide to tender their shares. This may discourage potential takeover bidders from participating in the market. Second, the rule drives down the return for shareholders tendering their shares. To compensate for the potentially greater takeover cost, a bidder must lower the initial offer price.[175] Assuming that the takeover premium—i.e., the actual value of the firm and the cost of the acquisition—is a fixed number, the possibility of higher takeover costs forces the bidder to offer fewer premiums to achieve the regular control premium. This loss is borne by both the controlling and minority shareholders, who may or may not be entirely compensated by the control premium.

Admittedly, it is difficult to quantify the actual loss created by the mandatory bid rule. There is no research so far that offers accuracy in

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[170] According to the U.S. Securities Regulations, the cap on non-control intent disclosure is 20%. *See* 17 C.F.R. § 240.13d-1 (2010).

[171] *See supra* note 169.

[172] Jeffery Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1597 (1989); EABORN, *supra* note 141, at 132–33. *See also* KRAAKMAN, *supra* note 34, at 257–59.

[173] *See, e.g.*, KRAAKMAN, *supra* note 34, at 257–59; Berglöf & Burkart, *supra* note 142, at 196–98; D. D. Prentice, *supra* note 142, at 409; Armour & Skeel, *supra* note 2, at 1738.

[174] Armour & Skeel, *supra* note 2, at 1738.

[175] KRAAKMAN, *supra* note 34, at 258.

weighing the resulting bid loss against the value gained from shareholder protection, controlling shareholder agency cost reduction, and premium sharing.[176] The mandatory bid rule has not been universally adopted across the world.[177] Further economic analysis is necessary to determine the overall effect of the rule in China. Nevertheless, a crucial consideration in deciding the desirability of the mandatory bid rule is whether a target company has an existing controlling shareholder. The distinction between the transfer of control from an existing controlling shareholder and from management absent a controlling shareholder is significant.[178] Many experts have already recognized the fundamental differences in the nature of the agency problems between controlled firms and non-controlled firms.[179] For a non-controlled firm, the fundamental concern is the management's incentive to behave opportunistically at the expense of shareholders. For a controlled firm, the concern is the controlling shareholder's own opportunism at the expense of non-controlling shareholders.[180] When a target company has a controlling shareholder, the benefit of a mandatory bid to minority shareholders is greater.[181] The rule requires the controlling shareholder to share some of the control premium with minority shareholders. The greater the control premium, the more benefit non-controlling shareholders can reap.[182] In contrast, for a target without a controlling shareholder, the rule can be detrimental for shareholders because the higher capital costs under the mandatory bid rule forces a bidder to offer less consideration.

It is no wonder then that the United States is not a follower of the mandatory bid rule, as the U.S. firms usually have widely dispersed ownership.[183] In contrast, the United Kingdom, where firms have more concentrated ownerships, has adopted the mandatory provision.[184] In China, the capital structure of the equity market is very complicated and grows more so as it continues to undergo drastic and rapid changes.[185] While many listed

[176] *Id.* at 259. *See also* Romano, *supra* note 1 at 157–68.

[177] *See* KRAAKMAN, *supra* note 34, at 164. All the member states of the European Union have introduced the mandatory bid rule, while the rule remains a controversial subject in the United States.

[178] *Id.* at 259.

[179] *See, e.g.*, Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117 (2007); Ronald J. Gilson & Jeffery N. Gordon, *Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003).

[180] Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest For Global Governance Standards*, 157 U. PA. L. REV. 1263, 1281–82 (2009).

[181] KRAAKMAN, *supra* note 34, at 259.

[182] John C. Coffee, *Regulating the Market for Corporate Control*, 84 COLUM. L. REV. 1145, 1283–89 (1984).

[183] *See generally* Armour & Skeel, *supra* note 2.

[184] *Id.*

[185] *See* sources cited *supra* note 4.

companies currently have controlling shareholders, such as state shareholders, China's aggressive economic reforms make tomorrow's capital structure unpredictable. Controlling state shareholders have sold most of their shares and left the equity market after the issuance of a 2001 State Council administrative decree to reduce state shareholding.[186] Changing the bid rule to an enabling one would allow each firm to adopt or reject the mandatory bid rule and design an optimal solution for itself, depending on its ownership structure. One example would be an opt-out mechanism that allows minority shareholders to release the company from the mandatory bid rule by their majority vote. Setting the mechanism as an opt-out instead of an opt-in ensures that non-controlling shareholders do not incur transaction costs if they wish to retain the protection of the mandatory bid rule. Given that many Chinese listed companies' capital structures are highly concentrated, this opt-out mechanism would give non-controlling shareholders a meaningful say. It is important to point out, however, that choosing this enabling rule incurs other forms of transaction costs.[187]

The rapidly changing market is not the sole reason for adopting the enabling bid rule. Unnecessary conformity to this one-size-fits-all regulation is not efficient for today's highly diversified equity market capital structure. The mandatory bid is merely one bulwark against takeover opportunism. Where its waiver necessitates minority shareholders' approval, it offers the greatest protection and shareholder value maximization. Additionally, the legislature can resolve any conflict between the Securities Law and the Measures, mentioned before, by adopting the enabling rule, which could slice the Gordian Knot.

3. More Detailed Squeeze-out Provisions

The "squeeze-out" right is very important in the process of going private after a successful control transfer. With this right, a successful bidder can dilute the remaining minority shareholders' property rights to extract enough

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[186] Guanyu Yinfa Jianchi Guoyougu Chouji Shehui Baozhang Jijin Guanli Zanxing Banfa de Tongzhi (关于引发减持国有股筹集社会保障基金管理暂行办法的通知) [Interim Notice on Reducing State-owned Stock Share to Raise Social Security Fund] (promulgated by the St. Council June 6, 2001, effective June 6, 2001), http://www.ssf.gov.cn/xxgk/flfg/200904/t20090427_910.html. For further discussion, see Lin Rongrong (李荣融), Daxing Kunnan Guoqi Lizheng 2008 Nian Quanbu Tuishi (大型困难国企力争 2008 年全部退市) [*Big SOEs Strive to Delist in 2008*], Zhenggong Yanjiu Dongtai (政工研究动态) [RES. TRENDS POL. BUS.], no. 17, 2005, at 1 (discussing the central government's plan of delisting big SOEs).

[187] *See* Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Law*, 89 COLUM. L. REV. 1599 (1989). The types of transaction costs vary across different cases. One example is that the enabling rule would also require investment in time and effort for acquiring information when deciding whether to retain the mandatory bid rule.

profits to encourage takeovers.[188] If there were no squeeze-out right, shareholders would be able to keep their shares and enjoy any post-takeover premium in cases where the new controller does institute improvements to the target company.[189] The squeeze-out right is therefore a takeover-friendly mechanism and can be found in the takeover laws of many jurisdictions.[190]

The Measures also allow for the squeeze-out mechanism.[191] Nevertheless, they fail to provide specific procedures for conducting a squeeze-out and calculating the squeeze-out price. To improve the squeeze-out rule, China should not look to simply transplant the advanced U.S. rule into its takeover laws. The U.S. rule is too complicated to achieve in China. For example, under the American rule, a merger squeeze-out requires a special committee of independent directors to negotiate the squeeze-out price with the new controller.[192] However, having a special committee is an expensive and alien concept for today's corporate China. Furthermore, not only is defining who qualifies as an independent director difficult, but it remains controversial whether the independent directors can maintain their independence. Additionally, the concept of a short form merger, a key type of squeeze-out mechanism, is not yet recognized by Chinese law. A simple importation of the U.S. rule will likely paralyze the judiciary and lead to misapplication. Therefore, the Chinese takeover legislation needs a more simplified and practical squeeze-out rule or framework in order to reduce the possibility that a controlling shareholder will arbitrage through an incomplete squeeze-out rule.

A pivotal idea of the squeeze-out rule is the fairness evaluation of the controlling shareholder's offer. The current law does not provide any parameter for calibrating the squeeze-out price when the price is paid in the form of non-publicly traded equity. This valuation problem, however, can be solved by requiring a third party, such as a bank or an accounting firm, to assess the value of the offered consideration. Once the valuation has been made, management should be obligated to protect minority shareholders from an unfair squeeze-out. Although there are risks in relying on an outside consultant's opinion, this third-party involvement provides minority shareholders with a relatively reliable benchmark that is preferable to no standard at all. With this preliminary reform as a starting point, the judiciary can further refine the general squeeze-out rule when the resulting breach of fiduciary duty claims are brought to courts.

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[188] Grossman & Hart, *supra* note 160, at 327.

[189] *Id.*

[190] For example, in the United States, the Williams Amendment to the Securities Exchange Act of 1934 recognizes that minority squeeze-outs play a role in the takeover process. *See id.* at 329.

[191] Measures for Administration of Takeovers, *supra* note 6, art. 44. *See also* PENG, *supra* note 4, at 284.

[192] Guhan Subramanian, *Post-Siliconix Freeze-outs: Theory and Evidence*, 36 J. LEGAL STUD. 1, 3 (2007).

B. Changes to the Private Enforcement Framework

1. Fiduciary Duty Jurisprudence

As mentioned in Part I.B, the Chinese legislature incorporated fiduciary duties into its business laws in 2005.[193] Many observers have noted the incompleteness of the fiduciary duty jurisprudence that has developed since then.[194] Take Article 8 of the Measures, for instance. The provision states that board members and senior executives may not show preference to any bidder and must base any antitakeover decision on the interests of the target company and its shareholders.[195] Although this "equal treatment" provision articulates general principles that board members and senior executives must follow, it is still vague and can be misleading in practice. First, "equal treatment" is extremely difficult to define and should be replaced by a more concrete standard. In a situation in which the board will inevitably have to pick one bidder over the others, absolute equal treatment for all bidders is impossible. If board members and senior executives help a bidder win the takeover battle for their own self-interests, then an action for a breach of the duty of loyalty would of course be available to shareholders. But as the provision now stands, the equal treatment requirement ties management's hands in normal business operations. Furthermore, its amorphous scope increases the possibility of frivolous litigation.

Current takeover fiduciary duties must be defined by a clear statutory provision that lays out the key standards. Fiduciary law is still considered overly abstract and difficult to implement in civil law jurisdictions.[196] Unlike the United States, where the Delaware Court of Chancery has refined and elaborated the scope of fiduciary duty,[197] the non-existence of case law in China has greatly reduced the judiciary's ability to clarify the legislative intent.[198] Therefore, it is even more important that the language of the statute clearly and unambiguously outline the scope of fiduciary duty. To identify key

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[193] Weng, *supra* note 55.

[194] *See, e.g.*, Rebecca Lee, *Fiduciary Duty Without Equity: "Fiduciary Duties" of Directors Under the Revised Company Law of the PRC*, 47 VA. J. INT'L L. 897 (2007); Luo, Li & Zhao, *supra* note 78.

[195] *See* Measures for Administration of Takeovers, *supra* note 6, art. 8. For a comparative perspective, note that under Delaware law, while a company management must maximize shareholder wealth under *Revlon*, under the *Unocal* test, the board may still consider a broader range of constituencies. *See supra* note 58 and accompanying text.

[196] Fan Jian & Jiang Daxing (范健 & 蒋大兴), Lun Gongsi Dongshi zhi Yiwu (论公司董事之义务) [*The Duties of Board Directors*], Nanjing Daxue Falü Pinglun (南京大学法律评论) [NANJING U. L. REV.], no. 1, 1998, at 92, 92–93.

[197] These seminal cases include: Moran v. Household Inc., 500 A.2d 1346 (Del. 1985); *Unocal Corp.*, 493 A.2d at 946; *Revlon, Inc.*, 506 A.2d at 173; *Paramount Communications Inc.*, 637 A.2d at 34; *Unitrin, Inc.*, 651 A.2d at 1361.

[198] SHEN, *supra* note 13.

standards of fiduciary duties, the Chinese legislature should look to other more sophisticated jurisdictions.

But while legislative efforts would help to determine the legitimate limits of antitakeover actions, situations in practice may vary, and the law on takeover fiduciary duty remains restricted by the limits of *lex scripta*. Thus, case precedent is a critical supplement to gaps in the statutes. In 2005, the Supreme People's Court of China mandated high courts to compile "Case Directives" and distribute them to lower courts to unify adjudication standards.[199] According to the mandate, research departments of higher courts should compile and publish periodical cases through intranet for the lower courts' reference.[200] Although the constitutionality and the applicability of Case Directives to subsequent litigation are still controversial, this is a good temporary solution to fill the gap between broad-brush regulations and rapidly changing takeover practices.[201]

2. Business Judgment Rule

The business judgment rule is a defense in the U.S. that allows directors to shield their managerial decisions from judicial scrutiny.[202] During a takeover, the target's board members may face great difficulties in deciding whether to accept or reject a bid, in addition to pressure from shareholders and the media. If excessive liabilities are imposed against target board members, they might lean towards unduly risk-averse measures.[203] To assuage this concern, the business judgment rule prevents judges, who might make biased decisions based on hindsight and lack of business expertise,[204] from meddling in

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[199] Renmin Fayuan Di Er Ge Wunian Gaige Gangyao (2004-2008) (人民法院第二个五年改革纲要 2004-2008) [The Second Five-Year Reform Plan for the People's Courts (2004-2008)] (promulgated by the Sup. People's Ct., Oct. 26, 2005, effective Oct. 26, 2005) SUP. PEOPLE'S CT. GAZ., Dec. 10, 2005, at 8, *available at* http://www.law-lib.com/law/law_view.asp?id=120832.

[200] Interview with anonymous judges at Zhejiang High Court and Shanghai First Intermediate Court (Nov. 22, 2010).

[201] For more information on the Case Directive Institution, *see* Weng, *supra* note 55, at 670-71.

[202] Joseph Hinsey IV, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine and the Reality*, 52 GEO. WASH. L. REV. 609, 610 (1985).

[203] Melvin Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 445 (1993).

[204] Experimental psychology has shown that in hindsight, people consistently exaggerate what could have been anticipated in foresight. ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD 119-20 (1988); Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 335, 341-43 (Daniel Kahneman et al. eds., 1982); Baruch Fischhoff

managerial decisions. For Chinese corporate courts, the lack of professionalization and judicial independence remains a significant issue.[205] Due to the asymmetry in Chinese economic development and the administratively-oriented judicial selection system, corporate judges in some jurisdictions are far less professional than those in other jurisdictions.[206] Also, local courts are susceptible to local government interference: in some regions, local governments have control over the financial resources of courts.[207] Thus, local courts might not be sufficiently independent to render neutral decisions.

Deference to target board members' business decisions and lack of a professional judiciary are compelling reasons for the Chinese legislature to introduce the business judgment rule. The rule would allow the judiciary to focus on board procedures, rather than engaging in a substantive review of board actions. Although the rule has not yet been incorporated into current business laws, the judiciary has already been applying the rule in corporate adjudications for several years.[208] The legislature should recognize this adjudicative norm and codify the business judgment rule to provide a statutory basis for this existing judiciary practice.

It is important to note that the core issues of takeover cases are more closely related to shareholder ownership rights than traditional concerns behind the business judgment rule. Most takeover disputes arise in the form of injunction proceedings, otherwise referred to as "transactional justification."[209] Therefore, the takeover business judgment rule usually requires extra judicial scrutiny. Under the American approach following *Van Gorkom*,[210] the takeover business judgment rule protects directors' decisions from stricter and more demanding judicial scrutiny once certain procedural conditions such as proper outsourcing or sufficient board meeting time are satisfied.[211] These conditions

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& Ruth Beyth, *"I Knew It Would Happen": Remembered Probabilities of Once-Future Things*, 13 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 1, 1–16 (1975).

[205] Weng, *supra* note 19, at 133–37.

[206] Su Li (苏力), Faguan Linxuan Zhidu Kaocha (法官遴选制度考察) [*A Probe into the Judge Selection System*], Faxue Yuekan (法学月刊) [LEGAL SCI. MONTHLY], no. 3, 2004, at 3, 4–8. *See also* He Weifang (贺卫方), Fuzhuan Junren jin Fayuan (复转军人进法院) [*Retired Military Officers Entering the Judiciary*], Nanfang Zhoumo (南方周末) [S. WKLY.], Jan. 2, 1998, *available at* http://article.chinalawinfo.com/Article_Detail.asp?ArticleID=26402; Taroh Inoue, *Introduction to International Commercial Arbitration in China*, 36 H.K.L.J. 171, 193 (2006).

[207] Jonas Grimheden, *The Reform Path of the Chinese Judiciary: Progress or Stand-Still?*, 30 FORDHAM INT'L L.J. 1000, 1011–12 (2007).

[208] Luo, Li & Zhao, *supra* note 78.

[209] E. Norman Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 DEL. J. CORP. L. 503, 506 (1986).

[210] *Van Gorkom*, 488 A.2d at 858.

[211] Weng, *supra* note 19, at 129 (describing the business judgment rule and conditions for its application).

are subject to additional judicial scrutiny in comparison to the level of judicial scrutiny under the traditional business judgment rule. Although the outsourcing of valuation to independent third parties has been criticized as a burden on the target company,[212] it is widely recognized as a cardinal method in evaluating the rationality of board's decision-making process. To facilitate private enforcement, the purpose of outsourcing should be clarified to restore its real legal function: protecting shareholders' value from being jeopardized by uninformed, self-interested, and reckless board decisions.

CONCLUSION

A careful examination of the Chinese takeover laws highlights a number of problems, some invited by anachronistic legislative approaches and others caused by gaps in the private enforcement regime. The CSRC's legal and political dependence on the central government limits its latitude in rule-making. The resulting pro-government philosophy has led to its SOE-friendly approach in market supervision. While the regulations are neither unequivocally shareholder-friendly nor takeover-friendly on their face, it is clear that they insulate SOEs from market discipline at the expense of other constituencies.

In light of the shift in the central government's focus and the landscape of capital market, the SOE-friendly approach of the CSRC is outdated and should be replaced. With the central government's emphasis on maintaining social stability, the CSRC should adjust its legislative approach from benefiting SOEs to maximizing overall shareholder welfare. Less frequent but more focused disclosure requirements, an opt-out mandatory bid rule, and a more explicit squeeze-out rule will enhance shareholder protection in takeover regulations. Moreover, to facilitate private enforcement, the scope of fiduciary duty should be clarified, and the current quasi-legislative/quasi-adjudicatory business judgment rule should be codified in takeover laws.

[212] Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983) (criticizing outsourcing as time consuming and redundant, even for corporate directors).