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USING WESTERN LAW TO IMPROVE CHINA'S STATE-OWNED ENTERPRISES: OF TAKEOVERS AND SECURITIES FRAUD

Guanghua Yu*

I. INTRODUCTION

Since 1978, the Chinese Government has tried various means, such as using Western law, to improve the inefficiency of State-owned enterprises ("SOEs"). Despite these efforts, the poor performance of SOEs at the macro-level has persisted.¹ However, the source of the poor performance remains less clear. The proper question is, "If a privately owned firm is socialized, and nothing else changes, how will the ownership change alone affect the firm's behavior?"² The question of ownership change is further complicated because government in industry is often associated with the suppression of competition, making it problematic as to whether public ownership or the suppression of competition is driving poor performance.³ Research in the property rights tradition⁴ and agency costs tradition⁵ suggests that there will be performance differences between government and private ownership because of a broad menu of monitoring mechanisms associated with private ownership. The underlying premise is that "[b]ehavior under public and private ownership is different because even with the same

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¹ Gang Fan & Wing Thye Woo, *State Enterprise Reform as a Source of Macroeconomic Instability: The Case of China*, 10 ASIAN ECON. J. 207 (1996) (arguing that SOEs were an important contributing factor of macroeconomic instability); see WORLD BANK, *THE CHINESE ECONOMY: FIGHTING INFLATION, DEPENDING REFORMS 15-7* (1996); WORLD BANK, *CHINA'S MANAGEMENT OF ENTERPRISE ASSETS: THE STATE AS SHAREHOLDER* (1997).

² Sam Peltzman, *Pricing in Public and Private Enterprises: Electric Utilities in the United States*, 14 J. L. & ECON. 109, 110 (1971).

³ Scott E. Atkinson & Robert Halvorsen, *The Relative Efficiency of Public and Private Firms in a Regulated Environment: The Case of U.S. Electric Utilities*, 29 J. PUB ECON. 281 (1986).

⁴ See Armen A. Alchian & Harold Demestz, *Production, Information, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

⁵ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

explicit organizational goals, the costs-rewards system impinging upon the employees and the 'owners' of the organization are different."⁶

Different results were found after studying a sample of nationalized companies in Japan and Germany in which the U.S. government held thirty-five to one hundred percent of the outstanding common shares between one and twenty-three years during and following World War II.⁷ The study indicated that the economic performance of the government-owned companies was not significantly different than that of private-sector firms in the same industry.⁸ Hence, the interim government custodianship of the firms in the study did not cause the effects normally attributed to government ownership. The study has limitations, however. First, the firms in the sample were subject to interim custodianship by the U.S. government rather than full-fledged government ownership. Second, the firms in the sample were eventually reprivatized. Third, the study did not have enough degrees of freedom to calibrate the relative importance of the monitoring mechanisms such as competitive markets, monitoring shareholders, and external valuation faced by the government in that case.

It has also been argued that, in addition to the lack of means to motivate or discipline agents in public organizations, public actors will pursue socially undesirable ends because of political self interest.⁹

This Article focuses, from an agency perspective, on Chinese SOEs that provide non-public goods or services. However, establishing various market mechanisms by utilizing Western law to improve the inefficiency of the SOEs is difficult. This Article argues that China cannot achieve the goal of using Western law to improve the inefficiency of SOEs unless the State withdraws or considerably reduces its ownership in the large number of State-owned listed companies.

After examining the reform of SOEs since 1978, Part II examines the problems in establishing an efficient market of corporate control despite transplanting of a Western-type takeover law.¹⁰ Part III discusses the

⁶ Armen A. Alchian, *Some Economics of Property Rights*, in *ECONOMIC FORCES AT WORK* 127-149 (1977).

⁷ Stacey R. Kole & J. Harold Mulherin, *The Government as a Shareholder: A Case from the United States*, 30 *J. L. & ECON.* 1 (1997).

⁸ *Id.*

⁹ Michael J. Trebilcock & Edward M. Iacobucci, *Privatization and Accountability*, 116 *HARV. L. REV.* 1422 (2003).

¹⁰ See *infra* Part II.

wide-spread existence of securities fraud in the issuing of shares in State-owned listed companies.¹¹ While focusing on the difficulty of enforcing a Western-type securities law to show the inefficiency in the public provision of goods or services, this Article also raises the doubts on Martha Minow's call for a public framework of accountability to be discussed in Part III.C.¹² If a public framework of accountability cannot be developed to deal with the abuse in SOEs, it is unlikely that such a framework will be very useful for private companies in market economies.¹³ This Article concludes that the political goal of maintaining control of large SOEs in China makes it difficult to establish efficient market mechanisms or legal means to motivate or discipline agents in China's SOEs.¹⁴ Further, this Article concludes that inefficient market or legal mechanisms adversely affect the performance of SOEs in China's transitional economy.¹⁵

II. THE HISTORY OF CHINA'S SOES AND THE LAW OF TAKEOVERS

Although the reform of SOEs started in 1978, the performance of SOEs and banks remained poor in the 1980s and at the beginning of the 1990s. In 1987, losses incurred by State-owned, economically-independent, industrial enterprises amounted to 6.1 billion yuan.¹⁶ These losses increased to 34.8 billion yuan in 1990, and to 45.2 billion yuan in 1993.¹⁷ During the first four months of 1994, 50.1% of these enterprises were running at a loss.¹⁸ Despite slight performance improvements during the latter half of 1994, 34.4% of these SOEs were still running at a loss by the end of 1994.¹⁹ Overstocking products, chain defaulting of loans, and poor funds management had taken an increasingly heavier toll on the economic performance of enterprises. For instance, stockpiled products accounted for the loss of 412.4 billion

¹¹ See *infra* Part III.

¹² See *infra* Part III.C (discussing Minow's public framework of accountability).

¹³ While the contractual and market mechanisms that can be used to motivate or discipline agents in companies include the capital, takeover, product, and managerial markets, shareholder monitoring, and creditor monitoring, this Article only examines takeover and capital markets.

¹⁴ See *infra* Part IV.

¹⁵ See *infra* Part IV.

¹⁶ Project Group for the Establishment of a Modern Enter. Sys., *Several Problems Related to the Establishment of a Modern Enterprise System*, SOC. SC. P.R.C. 19, 20 (Winter 1996). One U.S. dollar roughly equals 8.2 Chinese yuan.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

yuan at the end of 1994.²⁰ Most of these unpaid loans were used by medium to large-sized SOEs.

Despite the reform of the financial sector, performance of banks remained poor at the beginning of the 1990s. Overdue payments and non-performing loans were high. While official reports indicated that overdue payments and non-performing loans accounted for fifteen percent of all credit offered by banks in 1992,²¹ unofficial estimates showed that overdue payments and non-performing loans were close to forty percent of all outstanding loans.²² The dominant means of financing SOEs through loans from State banks generated political risks when banks were unable to tighten the soft budget constraints of various loan users.²³

Soft budget constraints, and the legal prohibition against banks from owning shares in non-financial companies, required the use of alternative means of financing corporate activities. The stock market was a natural selection. It has been argued that if the share system were adopted, worker-owners would have greater incentives to improve their enterprises.²⁴ It is also believed that stock market mechanisms were more efficient at rationalizing productive assets than the intermingling of government administration and enterprise management.²⁵ Moreover, the creation of a stock market would give enterprises more financial responsibility since the worker-investors would have to bear the cost of losses from the beginning.²⁶ China's company law and stock market were, therefore, mainly designed to improve the performance of inefficient SOEs.²⁷ The takeover market, the market for corporate control, is sometimes claimed to be able to discipline inefficient

²⁰ *Id.*

²¹ Zhou Zhengqing, "Explanations Concerning the Commercial Banking Law of the PRC," a Speech Delivered at the Ninth Session of the Eighth Standing Committee of the National People's Congress on August 24, 1994, GAZETTE OF THE STANDING COMMITTEE OF THE NATIONAL PEOPLE'S CONGRESS 19, 20-21 (May 30, 1995).

²² Interview with Mr. Cai, a middle level manager with the Bank of China, in Hangzhou, China (May 25, 1993).

²³ See Guanghua Yu, *The Relevance of Comparative Corporate Governance Studies for China*, 8 AUSTL. J. CORP. L. 49, 79-80 (1997) (discussing the difficulty of enforcing the Bankruptcy Law in China in the 1990s). See generally JANOS KORNAI, *ECONOMICS OF SHORTAGE* (D.W. Jorgenson et al. eds. 1980) (discussing soft budget constraints).

²⁴ See Xu Jing'an, *The State-Share System: A New Avenue for China's Economic Reform*, 11 J. COMP. ECON. 509, 510 (1987).

²⁵ *Id.* at 513.

²⁶ *Id.*

²⁷ Robert C. Art & Minkang Gu, *China Incorporated: The First Corporation Law of the People's Republic of China*, 20 YALE J. INT'L L. 273, 307 (1995).

managers and improve the allocation of productive resources. It is yet to be seen whether the use of an English-style takeover law will achieve such discipline and allocation.

A. *The Use of an English-Style Takeover Law*

China's early takeover transactions were regulated by the Tentative Regulations on the Administration of the Issuing and Trading of Shares ("ITS").²⁸ In the ITS, provisions on takeovers were very similar to the Hong Kong Code on Takeovers and Mergers,²⁹ which was itself based on the London City Code on Takeovers and Mergers.³⁰ Despite only seven articles on takeovers in the ITS, the key provision, Article 48, is based on the London City Code.³¹ According to Article 48:

[W]ithin 45 working days after any legal person's (other than a promoter's) direct or indirect holding of outstanding common shares in a listed company reaches 30% of such company's total outstanding common shares, such legal person shall make an offer of takeover to all the shareholders of such company, offering to purchase their shares through [cash] payment.³²

If a takeover is made, the higher of the following two prices should be adopted as the offer price: "(1) the highest price paid by the offeror for purchase of such shares during the 12 months preceeding the issuance of the takeover offer; [or] (2) the average market price of such shares during the 30 working days preceeding the issuance of the takeover offer."³³ I will call this provision the mandatory purchase provision.³⁴

²⁸ CHINA L. & PRAC. at 23 (August 1993) (providing an English translation of the ITS).

²⁹ *The Securities and Futures Commission of Hong Kong*, (P.R.C.), at <http://www.hksfc.org.hk> (last visited Oct. 28, 2004).

³⁰ The City Code on Takeovers and Mergers and the Rules Governing Substantial Acquisitions of Shares (U.K.), available at <http://www.thetakeoverpanel.org.uk> (last visited Oct. 28, 2004) [hereinafter London City Code].

³¹ *Id.* art. 9.1.

³² CHINA L. & PRAC., *supra* note 28, at 34 (art. 48). SOEs and companies are legal persons, but branches and partnerships are not legal persons in Chinese law. A legal person shall have the following qualifications: (1) establishment in accordance with the law; (2) possession of the necessary property or funds; (3) possession of its own name, organization, and premises; and (4) ability to independently bear civil liability. *The General Principles of Civil Law* (art. 37), in THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 225 (Foreign Languages Press 1987) (art. 37) [hereinafter *General Principles*].

³³ *General Principles*, *supra* note 32, at 225. The current price provision in the Procedures on the Administration of the Takeover of Listed Companies issued by the China Securities

A few other provisions are related to the fair treatment of minority shareholders and are much easier to justify. For instance, Article 50 states that “[a]ll the conditions contained in a takeover offer shall apply to all the holders of the same kind of shares.”³⁵ Article 51 further clarifies that “[i]f the total number of shares that [offeror] offers to buy is less than the total number of shares for which the offer is preliminarily accepted, the offeror shall purchase such shares from the preliminarily accepting offeree [shareholders] on a pro rata basis.”³⁶ Article 52 states:

In the event of a change in any of the main conditions of offer after a takeover offer has been issued, the offeror shall promptly notify all offerees. Such notification may be made in the form of a press conference or newspaper announcement or by another means of dissemination. During the term of a takeover offer and for a period of 30 working days thereafter, the offeror may not purchase the shares in question on any conditions other than those set forth in the offer.³⁷

Still other provisions are related to disclosure and the facilitation of potential competing takeover offers. Article 47 states that if a legal person holds, pursuant to the disclosure provision, directly or indirectly, more than five percent of the common shares of another listed company, a public announcement shall be made and a written report disclosing the fact shall be sent to the listed target company, the relevant stock exchange, and the China Securities Regulatory Commission (“CSRC”) within three working days from the date of acquisition.³⁸ In addition, Article 47 states that any change of the above acquired shares of such a legal person reaching two percent will again trigger the reporting duty.³⁹ Such a legal person shall not directly or indirectly buy or sell shares of the target company within two working days from the announcement

Regulatory Commission on September 28, 2002, follows the higher of the highest price the acquirer paid during the six months prior to the date of public announcement, or ninety percent of the arithmetic mean of the daily weighted average prices of the target company’s listed shares of that class during the thirty days prior to the date of public announcement. *Administration of the Takeover of Listed Companies Procedures*, CHINA L. & PRAC. 43 (Nov. 2002) [hereinafter *Administration*].

³⁴ See *infra* Part II.B (discussing the mandatory purchase provision).

³⁵ CHINA L. & PRAC., *supra* note 28, at 34 (art. 50).

³⁶ *Id.* at 35 (art. 51).

³⁷ *Id.* (art. 52).

³⁸ *Id.* at 33-34 (art. 47).

³⁹ *Id.* at 34 (art. 47). The current position is five percent pursuant to the Securities Act of 1998 instead of two percent.

date and before the submission of the report.⁴⁰ According to Article 49, aimed at facilitating takeover offers, the takeover offer period, calculated from the offer-issuing date, shall not be less than thirty working days, and offerors shall not withdraw their takeover offers during the offer period.⁴¹ Furthermore, Article 53 states that the offeree shareholders have the right to withdraw their acceptances at any time during the offer period.⁴² As will be discussed later, the political goal of maintaining control over the large SOEs has made the disclosure provision and the provision for facilitating competing takeover offers irrelevant in the 1990s.⁴³

B. Mandatory Purchase Provisions

The mandatory purchase provision is a special feature of the English-style takeover law. U.S. takeover law does not have such a provision. The rationale behind the mandatory purchase provision is equality in the treatment of minority shareholders. If an acquiring company pays a premium to the majority, block, or some shareholder(s) in a target when purchasing their shares, the acquiring company will also be required to extend the same premium to the minority shareholders in the target company. An introductory provision in the London City Code reflects this policy concern. Section 1(a) stipulates that the Code is “designed principally to ensure fair and equal treatment of all shareholders in relation to takeovers.”⁴⁴ This rationale, however, is based on an unrealistic assumption that whatever the law, the number of takeovers will not be reduced. The provision takes the ex post view that the gains from takeovers should be shared equally by all the shareholders in the target once a takeover occurs.⁴⁵

The mandatory purchase provision can be evaluated by the autonomy value and the welfare value. Neither criterion can justify this premium sharing provision. From a Nozickian rights-based approach, a

⁴⁰ *Id.* (art. 47).

⁴¹ *Id.* (art. 49).

⁴² *Id.* at 35 (art. 52).

⁴³ *See infra* Part IV.

⁴⁴ London City Code, available at <http://www.thetakeoverpanel.org.uk> (last visited Oct. 28, 2004).

⁴⁵ *See* Gregg Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988); Michael Jensen & Richard Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983) (providing empirical evidence that takeovers are more likely to produce social gains).

distinction is made between threats and offers.⁴⁶ Threats reduce the possibilities open to the recipient of a proposal, whereas offers expand them. Threats are therefore coercive, while offers are not. From that perspective, takeovers would seem properly viewed as offers rather than as threats. The possibility of having a new management team indicates that takeovers increase target shareholders' possibilities relative to their positions prior to their interactions with the acquirer. Without takeovers, shareholders in target companies may stay with these companies while the company stagnates or simply dies from insolvency. Even the threat of takeovers disciplines managers in a potential target company.

Despite the conclusion that takeover transactions enlarge shareholders' contractual possibilities, and despite the overwhelming empirical evidence that shareholders of target companies receive abnormal returns resulting from takeover transactions, an enormous body of academic writing has focused on the problem of coercion in takeovers, particularly in partial bids.⁴⁷ It has been noted that "demonstrated examples of coercion remain as rare as confirmed sightings of the Loch Ness monster."⁴⁸ The ex ante Nozickian rights-based approach provides little justification for the mandatory purchase provision.⁴⁹ If takeovers enlarge the opportunities of the target shareholders, as they are considered offers rather than threats, mandatory purchase provisions cannot be justified. Even from the perspective of the remaining target shareholders, mandatory purchase provisions may reduce contractual opportunities as the heavy burden of the provision on the acquirer could result in few takeovers ex ante. Ex post, mandatory purchase provisions may be viewed as offers to particular offeree shareholders in the target because they can choose to either sell their shares to the acquirer at a premium or remain in the target and expect the improvement of the target by the acquirer. Mandatory purchase provisions, however, are certainly threats to the shareholders in the acquiring company. If takeovers do not create third party effects of coercion on the remaining shareholders in the target, it is

⁴⁶ Robert Nozick, *Coercion*, in PHILOSOPHY, SCIENCE, AND METHOD 447, 447-453 (Sindey Morgenbesser et al. eds, 1969).

⁴⁷ See Michael Bradley & Michael Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377 (1986); Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983).

⁴⁸ John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stateholders and Bust-Ups*, 1988 WIS. L. REV. 435, 459.

⁴⁹ See *supra* note 46 and accompanying text (discussing Robert Nozick's rights-based philosophy).

not clear why the contractual relation between the acquirer and part of the shareholders in the target should be restrained.

Autonomy value—the concept that allowing an individual to freely determine his own affairs is fundamental and paramount to the moral enterprise—provides little support for mandatory purchase provisions.⁵⁰ Likewise, welfare value—the assessment of contractual relationships to determine whether a contractual arrangement would enhance or reduce the economic well-being of the contractual parties or third parties to determine whether government intervention is necessary—would also oppose the use of the mandatory purchase provision.⁵¹ Mandatory purchase provisions increase the cost of acquiring the control of target companies. The harmful effects of the mandatory purchase provision are obvious. In the first place, mandatory purchase provisions reduce the number of offers by making targets more expensive to acquire. According to the economic law of supply and demand, the higher the price, the lower the demand from purchasers. Lower demand in the context of takeovers means fewer takeovers, hence, possibly a smaller pie for society. Second, the philosophy of sharing the gains from takeover transactions contained in the mandatory purchase provision reduces the return of investment on the part of the acquirer. The inability of acquirers to appropriate the full value of their investments will lead them to undertake too few takeovers.

This is the classic public good problem.⁵² The proper management of an inefficient target company is a public good to all the shareholders of the target. It has also been pointed out “that there are significant costs in ensuring that directors/managers act in the interest of the [shareholders]. If one shareholder [acquirer] devotes resources to improving management, then all shareholders benefit.”⁵³ The mandatory purchase provision exacerbates the problem that the costs will be borne by third parties, or externalities, by allowing even the remaining shareholders of the target company to equally share takeover

⁵⁰ See Melvin A. Eisenberg, *The Theory of Contracts*, in *THE THEORY OF CONTRACT LAW* 223-40 (Peter Benson ed. 2001); MICHAEL J. TREBILCOCK, *THE LIMITS OF FREEDOM OF CONTRACT* 241-68 (1993).

⁵¹ TREBILCOCK, *supra* note 50, at 241-68.

⁵² See Paul Samuelson, *The Pure Theory of Public Expenditure*, 36 *REV. ECON. & STAT.* 386 (1954) (discussing the nature of public goods).

⁵³ Sanford Grossman & Oliver Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 *BELL J. ECON.* 42, 59 (1980); see also Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 *YALE L. J.* 698, 705-706 (1982) (providing a similar discussion of the problem of freeriders and externality in the context of freezeouts).

gains. This severe externality problem indicates that it cannot be assumed that a company that is not being run in the interests of shareholders will always be vulnerable to a takeover bid. An antidote to this externality problem is to exclude the remaining shareholders in the target from sharing equal gains resulting from takeovers *ex post*, hence, an argument for abolishing the mandatory purchase provision at least at the low threshold of holding thirty percent of outstanding common shares.

C. Chinese Stock Exchange

To understand how the imported takeover law adjusts to China's local conditions, we need to understand the ownership structure of the listed companies on the two stock exchanges. As discussed previously, both the development of China's corporate law and the establishment of the stock market at the beginning of the 1990s were closely related to the reform of SOEs.⁵⁴ A survey taken in May of 1999 revealed that among the 862 listed companies on the two stock exchanges, State-shares existed in 541, or 62.76% of the companies.⁵⁵ Among the 541 listed companies, State-shares accounted for 45% of the total issued shares in these companies.⁵⁶ In 473 listed companies, the State shareholder had either absolute or relative control of the company, occupying 87.43% of the 541 listed companies.⁵⁷ The State-shares were mainly held by State Asset Administration Bureaus ("SAAB"), State investment companies, or the parent companies of the State-owned listed companies.⁵⁸ In 70.79% of the 541 listed companies, State-shares ranged from thirty to eighty percent.⁵⁹ Different from the shares held by individuals, which are traded at the two stock exchanges, State-shares and legal-person-shares of SOEs are not traded on the stock exchanges. Another statistic shows

⁵⁴ See *supra* notes 16-27 and accompanying text (discussing the development and reform of the Chinese stock market).

⁵⁵ Zhang Zongxin & Sun Yewei, *The Optimization of Shareholding Structure and the Improvement of Corporate Governance in Listed Companies*, 1 *ECON. REV.* 36 (2001).

⁵⁶ *Id.*

⁵⁷ Absolute control means that the State controls more than fifty percent of the issued shares, and relative control means that the State controls more than thirty percent of the issued shares. Infobank, available at <http://www.chinainfobank.com> (last visited Oct. 28, 2004); Zhang & Sun, *supra* note 55.

⁵⁸ Zhang & Sun, *supra* note 55, at 36. The percentage of State ownership is much higher because State ownership may be held by legal persons of State-owned companies. *Id.*

⁵⁹ *Id.*

that traded shares owned by individual investors in most listed companies are only between twenty-five to forty percent.⁶⁰

The structure of shareholding in most listed companies makes it impossible for an acquiring company to accumulate control through buying shares on any stock exchange. So far, there has been no successful acquisition of control of a listed company by purchasing shares on the stock market. To acquire a sufficient percentage of shares in a target listed company, instead, requires the purchase of part of the non-traded shares owned by the State or other companies. This makes the negotiated takeover the preferred method of takeovers in China. Under this method, an acquiring company negotiates with a majority or block shareholder and enters into a share transfer agreement with that shareholder in the target listed company.

D. Negotiated Takeovers

Negotiated takeovers in China, however, have to overcome some procedural and legal hurdles. On the procedural side, acquiring State-owned shares or legal person shares of SOEs requires approval by the relevant authority. Article 29 of the Provisional Measures on the Administration of State-Owned Shares of Joint Stock Companies provides that the transfer of State-owned shares needs the approval of the SAAB and the provincial government.⁶¹ Transferring more than thirty percent of the State-owned shares in a listed company requires the joint approval of the SAAB and the State Economic Restructuring Commission.⁶² The approval procedure is consistent with the goal of maintaining governmental control of large SOEs on the stock market.

In addition to overcoming this procedural hurdle, negotiated takeovers must comply with the requirement of the mandatory purchase provision, which is central to the London City Code. The cost of following such a mandatory purchase provision is well recognized by regulators in China.⁶³ The practice of dealing with negotiated takeovers and the adjustment of English-style takeover law to the Chinese takeover

⁶⁰ Zhang Rui, *A Legal Analysis of Negotiated Takeovers of Listed Companies*, JILIN UNIV. J. SOC. SCIENCES 108, 109 (July 2003).

⁶¹ These administrative rules were jointly issued by the SAAB and the State Economic Restructuring Commission on November 3, 1994. Infobank, available at <http://www.chinainfobank.com> (last visited Oct. 28, 2004).

⁶² *Id.*

⁶³ Zhang Xin, *Legislation and Regulation of Takeovers of Listed Companies*, SEC. MARKET HERALD, August 2003, at 12.

market reflects the concern that strictly following the mandatory purchase provision is inefficient.

The first negotiated takeover took place in 1994, under the early takeover regime.⁶⁴ Hengtong Investment, Ltd. (“Hengtong”) was incorporated in Zuhai in 1981. Focusing on real estate development, Hengtong also developed in areas of shipping, communications, textiles, and electronic products. To market its electricity meters in Shanghai, Hengtong planned to acquire a property development company in Shanghai. Search efforts revealed that Shanghai Lingguang, Ltd. (“Lingguang”), which produced glass and electronic components, was a suitable target. Lingguang issued 33.8 million shares total. Among all the issued shares, Shanghai Construction, Ltd. held 55.26% of the shares on behalf of the State, while individual investors and legal person investors accounted for 32.55% and 11.89% of the shares, respectively. Shortly before the transfer of control, shares of Lingguang were trading at around thirteen yuan per share on the secondary market. Hengtong’s motivations of acquiring a controlling block of Lingguang shares were twofold. First, Hengtong was motivated mainly to rely on Shanghai Construction’s connection with the property market in Shanghai. Secondly, the motivation was partly to take advantage of Lingguang’s technology. The deal was encouraging news to Lingguang and Shanghai Construction based on the information then available, as Lingguang was short of funds to carry out ambitious development projects. An agreement was reached among Hengtong, Shanghai Construction, and Lingguang to transfer 35.5% of the shares held by Shanghai Construction to Hengtong at the price of 4.3 yuan per share on April 28, 1994. Transferring more than thirty percent of the shares of a target, however, triggered the mandatory purchase provision. To avoid the high cost of mandatorily purchasing the remaining shares of Lingguang, Hengtong applied to the CSRC for an exemption from the mandatory purchase requirement. The CSRC granted an exemption, mainly on the ground that the transferred shares were the non-trading, State-owned shares.

The Hengtong case raises a number of questions. Could the CSRC approve the transfer price of 4.3 yuan per share when the individual shares traded on the secondary stock market were around thirteen yuan per share? Is the significant discount of control shareholding able to ensure that the productive resources of the target would move towards a more efficient purchaser? Another question is by which legal grounds

⁶⁴ CHEN GONG ET AL., EDS, *PRINCIPLES AND CASES OF CORPORATE MERGERS AND TAKEOVERS* 421-425 (Renmin Univ. Press, 1996).

did the CSRC give the exemption from the mandatory purchase obligation, because the ITS contains no legal provision conferring discretion upon the CSRC to grant exemptions. The lack of a legal provision, of course, did not constrain the CSRC when the rule of law granting exemptions was not deeply entrenched in China. Finally, should China follow the U.S. approach by exempting the transfer of control through an agreement under the need of protection test if it is well recognized that the cost of following the English mandatory purchase provision is too high?⁶⁵

E. Developments in Takeover Law

Later development of the takeover law partially addressed the issues arising from Hengtong. The Securities Law⁶⁶ modified the mandatory purchase provision and deliberately gave the CSRC the discretion to exempt acquirers from following the mandatory purchase requirement if they acquired shares through any stock exchange.⁶⁷ The modified mandatory purchase provision now provides that if an investor holds thirty percent of the issued shares of a listed company and continues to buy such shares through a stock exchange, the investor shall make a takeover offer to all the shareholders of the listed target company.⁶⁸ The Securities Law seems to make a difference with respect to negotiated takeovers. Article 89 of the Securities Law stipulates:

In the case of takeover by agreement, the [acquirer] may effect the equity transfer by entering into an agreement with the shareholders of the target company, as prescribed in laws and administrative regulations. When a listed company is taken over by agreement, the [acquirer] must, within three days after the agreement is reached, submit a written report on the takeover agreement to the State Council's securities regulatory authority and the stock exchange, and make an announcement.⁶⁹

⁶⁵ *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 27 (2d Cir. 1985).

⁶⁶ See *Securities Laws*, CHINA L. & PRAC., at 25 (February 1994) (providing an English translation of the law promulgated on Dec. 29, 1998, that became effective on July 1, 1999) [hereinafter *Securities Laws*].

⁶⁷ *Id.* at 42 (art. 81).

⁶⁸ *Id.*

⁶⁹ *Id.* at 43-44 (art. 89).

Article 89 appears to be based on the need of protection test found in U.S. securities regulation, which is based on the theory that selling shares by sophisticated investors does not need the protection of the law.⁷⁰ It is relatively clear that Article 89 does not expressly compel the acquirer to make an offer to all the shareholders in a negotiated takeover. Nor does Article 89 require the acquirer to obtain approval from the CSRC for such a negotiated takeover, except for the compliance with the reporting and announcement requirement. Article 89 seems to recognize the high cost of the mandatory purchase provision and the need of a corporate control market to improve the inefficient State-owned listed companies. However, Article 89 has not been used in that way. The CSRC's position is that, whatever the method of acquiring control, the mandatory purchase provision must be complied with unless it has granted the acquirer a waiver. This position is consistent with the practice of negotiated takeovers in China: By the end of 2000, 121 negotiated takeovers had followed the pattern of Hengtong by obtaining a waiver from the CSRC.⁷¹

F. *Negotiated Takeovers Reconsidered*

As discussed previously, most of China's SOEs on the stock market are not very efficient. A study has found that there is a negative correlation between firm performance and the percentage of State-owned shares.⁷² Empirical evidence in another study suggests that takeovers in China are largely efficient compared with the status of many companies before the takeover, although the market could be more efficient if ideological issues are dealt with properly.⁷³

The inefficiency of the State-owned listed companies and the need of an active takeover market to facilitate the reallocation of productive resources requires China to modify the English-style takeover law in the Chinese takeover environment. This objective has led the CSRC to reconsider its position on negotiated takeovers. In 2002, the CSRC issued the Procedures on the Administration of the Takeover of Listed

⁷⁰ *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584 F.2d 1195 (2d Cir. 1978); see *Hanson Trust PLC*, 774 F.2d 47.

⁷¹ Li Bingan, *A Discussion of the Exemption from the Mandatory Purchase Provision*, 18(6) LEGAL F. 50 (Nov. 2003).

⁷² He Xiaogang, *Management Buyouts: The Status Abroad, Research, and Development in China*, 4 REFORM 54 (2003).

⁷³ Fei Yiwen & Cai Mingchao, *An Analysis of the Takeover Effects of Listed Companies on the Shanghai Stock Exchange*, 5 WORLD ECON. 64 (2003).

Companies (“Takeover Procedures”).⁷⁴ The Takeover Procedures reaffirm the position of the CSRC that, whatever the method of acquiring more than thirty percent of the shares in a target listed company, the mandatory purchase requirement must be complied with unless exemption from the CSRC is obtained.⁷⁵ However, the Takeover Procedures have also provided numerous grounds upon which the CSRC is prepared to grant a waiver.

Some of the waiver exceptions are related to debt restructuring and insolvency reorganization. For instance, a waiver will be given if the transfer of shares is applied for on the basis of a court ruling and results in the percentage of shares held or controlled by the purchaser exceeding thirty percent of the listed company’s issued shares.⁷⁶ A waiver will also be provided if a bank, during the ordinary course of business, has acquired more than thirty percent of the issued shares of a listed company, even though the bank has no intention or has taken no action to actually control such a listed company, and has made arrangements to transfer the excess shares to non-affiliated parties.⁷⁷ An insolvency waiver is provided to an acquirer that is taking over a listed company in financial distress in order to rescue it under a proposed and feasible restructuring plan.⁷⁸

Other waiver exceptions are based on the ground that no shareholder in a target listed company has received a takeover premium, such as when an acquirer accumulates more than thirty percent of the shares of a listed company resulting from the company’s issuing new shares.⁷⁹ Another waiver exception is allowed where the acquisition of more than thirty percent of the issued shares of a listed company is caused by the reduction of the capital of the company.⁸⁰

In the past, the CSRC frequently gave waivers if the administrative transfer of State-owned shares had caused the transferee to hold or control more than thirty percent of the issued shares of a listed company.⁸¹ This exemption remains under the new Takeover Procedures. Finally, the Takeover Procedures have added a catchall

⁷⁴ *Administration, supra* note 33, at 43.

⁷⁵ *Id.* at 45-46 (arts. 13-14, 23).

⁷⁶ *Id.* at 56 (art. 49(4)).

⁷⁷ *Id.* (art. 51(4)).

⁷⁸ *Id.* at 55 (art. 49(2)).

⁷⁹ *Id.* (art. 49(3)).

⁸⁰ *Id.* at 56 (art. 51(2)).

⁸¹ *Id.* at 57 (art. 51(5)).

provision, giving the CSRC the discretion to waive the mandatory purchase provision if the CSRC considers it necessary to meet the needs of the development and changes of the securities market and the need to protect the legitimate rights and interests of investors.⁸² The transfer of control through administrative means as practiced in the past has made the mandatory purchase provision largely irrelevant. If the catch-all provision is also liberally used, the mandatory purchase provision will also be made partly irrelevant.

The discussion of the adjustment of the English-style mandatory purchase provision clearly shows that application of the provision in China is path-dependent. The political goal of maintaining control of the State-owned listed companies has completely changed the rationale of using such a provision. The past socialist system of public ownership of the means of production created interested parties that controlled both the political and economic resources. These interested parties will try to protect their vested rights and interests. An easier way of continuing their control is to maintain the control of the large State-owned listed companies. The insistence of this political goal requires a different way of using the law of takeovers. China's developing securities market can be properly understood only in the context of its underlying motivation, by carefully avoiding the mistake of assuming that adoption of western-style structures and laws implies movement toward western goals.⁸³

If we take the ex ante efficiency view discussed previously, the adjustment of the imported takeover law is very positive in the sense of achieving the primary goal of improving the large number of inefficiently run State-owned listed companies. Another positive use of English-style takeover law is the adoption of non-frustration on the part of the directors in a target listed company when facing a takeover offer.⁸⁴ Article 33 of the Takeover Procedures provides that the decisions made and measures taken by the directors, supervisors and senior management of the target company with respect to the takeover offer made by an acquirer may not prejudice the legitimate rights and interests of the company or its shareholders.⁸⁵ More specifically, Article 33 prohibits the adoption of measures of issuing new shares or

⁸² *Id.* at 56-57 (arts. 49(5), 51(7)).

⁸³ Art & Gu, *supra* note 27.

⁸⁴ London City Code, available at <http://www.thetakeoverpanel.org.uk> (last visited Oct. 28, 2004) (General Principle 7).

⁸⁵ *Takeover Procedures*, CHINA L. & PRAC. 51-52 (Nov. 2002) (art. 33) [hereinafter *Takeover Procedures*].

convertible bonds, the repurchase of its own shares, the amendment of articles of association, and the signing of contracts, which could have a major effect on the company's assets, liabilities, rights, interests, or business outcomes, except in the ordinary course of business, after an acquirer has announced its takeover intention.⁸⁶

G. *U.S. Takeover Practice*

In the United States, controversy surrounds whether the board of directors or the shareholders should be given the ultimate power to decide whether the corporation should be sold to a bidder that offers to buy all the corporation's shares at a substantial premium above the current stock market price. Judge Frank Easterbrook and Professor Daniel Fischel argue that management should remain completely passive in the face of a takeover bid.⁸⁷ Their argument is based on the assumption that most takeovers are efficient in that they discipline inefficient managers in the target.⁸⁸ When inefficient managers are facing a takeover bid that tends to remove them, it is unlikely that their action to defeat the takeover will be for the best interest of the target corporation.⁸⁹ Professor Lucian Bebchuk argues that, once mechanisms to ensure undistorted shareholder choice are in place, boards should not be permitted to block offers beyond the period necessary for putting together alternatives for shareholder consideration.⁹⁰ In contrast, Martin Lipton argues against a regime of shareholders voting and no board veto.⁹¹ According to Lipton, there are significant costs to corporations in being managed as if they were constantly for sale.⁹²

The Delaware General Corporation Law ("DGCL") takes a middle ground. The DGCL gives the board of directors a central role in

⁸⁶ *Id.*

⁸⁷ See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

⁸⁸ *Id.*

⁸⁹ See Alan Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. L. STUD. 165 (1988) (providing a similar view as Easterbrook and Fischel). Inefficient managers in the target company can be disciplined when the acquiring company has taken over the target and replaced the inefficient managers with efficient and responsible managers. In other words, the inefficient managers can be disciplined by the loss of their jobs after a takeover.

⁹⁰ Lucian Ayre Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).

⁹¹ Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002).

⁹² *Id.* at 1061-1062.

corporate decision-making,⁹³ but it also requires stockholder consent for many fundamental transactions.⁹⁴ The DGCL is, however, silent on the most contentious question in the debate: In what circumstances, and to what extent, are directors empowered to prevent shareholders from accepting a tender offer? The Delaware courts also takes a middle ground. While in principle Delaware case law holds that the purpose of the corporation is to maximize the wealth of its stockholders,⁹⁵ Delaware decisions also give directors substantial authority to deploy the powerful weapon of a poison pill,⁹⁶ and to block takeover offers that appear to be in the best interests of the current array of stockholders.⁹⁷ The Delaware courts, however, have subjected defensive measures to a heightened form of judicial review under which directors must prove the reasonableness and good faith of their actions.⁹⁸ The result is a regime in which directors are given substantial authority to forge corporate strategies while leaving room for stockholders to vote down management-preferred directors and to use the election process to avail themselves of a tender offer.⁹⁹

The adoption of the English-style mandatory purchase provision at the beginning of 1990s has educated regulators in China relatively well on other parts of the London City Code. When the CSRC issued the Takeover Procedures in 2002, it again chose the English position of non-frustration over the Delaware-type of takeover law on the proper role of the target board when the target is facing a takeover offer.¹⁰⁰ The choice for the English-style purchase provision is largely satisfactory in the context of China for at least two reasons. First, Delaware law is very complicated. At this stage, regulators and judges in China are still not sophisticated in takeover law. To expect them to administer the Delaware-type of takeover law when even the judges in other parts of the United States are not able to do so is likely to be counterproductive. Second, directors in the United States are subject to greater constraints by

⁹³ See, e.g., DEL. CODE ANN. tit. 8, § 141 (2001).

⁹⁴ See, e.g., *id.* § 251 (referring to mergers); *id.* § 271 (referring to the sale of substantially all the assets of the firm).

⁹⁵ See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993).

⁹⁶ See, e.g., *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1390 (Del. 1995).

⁹⁷ See, e.g., *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1990).

⁹⁸ See, e.g., *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985).

⁹⁹ See generally William Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002) (discussing the theoretical debate on takeovers in the United States and the current status of Delaware law on takeovers).

¹⁰⁰ See *supra* note 65 and accompanying text.

very strict fiduciary duties, derivative suits, and various market mechanisms that are not available in China.¹⁰¹

H. Negotiated Takeover Defects

While the adoption of English-style takeover law and the adjustment of the law in China are headed in the right direction, negotiated takeover transactions have a serious defect. As discussed previously, only shares held by individuals in listed companies are traded on the two stock exchanges, while State-shares and legal person shares of SOEs are not traded on the stock exchanges. This raises the issue of pricing the control block of State-owned shares. In the Hengtong case, the control block was priced at 4.3 yuan per share when the shares traded on the stock exchange were around thirteen yuan per share.¹⁰² The Opinions Concerning the Exercise of State-Owned Shares in Joint Stock Companies¹⁰³ dictates that the lowest transfer price of State-owned shares is the net asset value per share.¹⁰⁴ In Hengtong and all the other cases before 2004 when the control block of State-owned shares was transferred, the price of the shares of the block was several times lower than the price of the shares traded on the stock market.¹⁰⁵ In a few cases, even the requirement of the lowest transfer price of net asset value per share is not followed.¹⁰⁶

The practice of negotiated takeovers in China also indicates why the mandatory purchase provision, which is central to the London City Code, is not followed in China. The mandatory purchase provision is based on the premise that the acquirer has to extend the same premium to all other shareholders if he buys shares at a price higher than the market price from either the majority, block, or some shareholders, that are more likely to get the benefits because of their positions. This ensures equality of treatment for all shareholders in the target. In China, when the control block is priced at a much lower price than the market price of other shares traded on the stock market, the mandatory

¹⁰¹ See Zhang Xin, *supra* note 63 at 15-17 (illustrating the regulator's view).

¹⁰² CHEN GONG ET. AL, *supra* note 64.

¹⁰³ *The Opinions Concerning Exercise of State-Owned Shares in Joint Stock Companies*, (Aug. 29, 1997) available at <http://www.chinainfobank.com/IrisBin/Text.d11?db=FL&no=11092&cs=102> (providing opinions jointly issued by the SAAB and the State Economic Restructuring Commission).

¹⁰⁴ *Id.* (Art. 17).

¹⁰⁵ CHEN GONG ET AL., *supra* note 64.

¹⁰⁶ An Chunmei & Dou Zhanguo, *An Analysis of Benefits and Risks of Management Buyouts in Listed Companies*, 7 FIN. AND ACCT. RES. 52 (2002); Wang Huacheng & Tong Yan, *Management Buyouts in China: The Case of Media*, 10 ECON. THEORY AND MGMT. 66 (2002).

purchase provision loses its rationale. Obviously, the CSRC and the government are more interested in the facilitation of the reallocation of the productive resources of State-owned listed companies, and the interest of minority shareholders is to a large extent ignored. This again leads to the conclusion that the political goal of maintaining the control of State-owned listed companies has made the imported law considerably irrelevant. While not following the mandatory purchase provision can be justified on efficiency grounds, the cheap transfer of control blocks in China has left minority shareholders with no adequate protection.

In the United States and the United Kingdom, the concern of takeover law is to ensure minority shareholders a premium over the market price. Because of the benefits of control, the price of the control block is normally higher than the price of the shares of a target on the secondary market. The higher price of the control block is a basic market mechanism to protect the minority shareholders in that, given the constraints, only those who are able to manage the target better can obtain control. There may be mistakes in prediction or judgment on the part of the acquirer, and the effect of takeover may be disastrous. Yet, the market in the long run will correct the mistakes. The cheap transfer of control in China, however, is not able to ensure that acquirers are necessarily better than the existing management in targets. Furthermore, the discount of the share price of the control block creates serious risks of exploiting minority shareholders. In January 2004, the SAAB and the Ministry of Finance jointly issued the Provisional Measures on the Administration of the Transfer of State-Owned Shares ("Provisional Measures").¹⁰⁷ The Provisional Measures now permit, but do not compel, the use of auctions or biddings in takeovers in addition to negotiated takeovers.¹⁰⁸ Similar to other administrative rules, however, the Provisional Measures are more interested in ensuring that the State-owned assets are not depleted in the low price transfer of control to private enterprises rather than liberalizing the control of SOEs.

While auctions and biddings in takeovers will alleviate the problem of cheap transfer of control of listed companies in China, the move towards an efficient takeover market requires a radical reform of the large-scale exit of SOEs in many sectors of the economy. SOEs are unlikely to be efficient as there are no adequate means to motivate the agents in SOEs or to discipline such agents compared with the means

¹⁰⁷ *Provisional Measures*, (Aug. 23, 2004), available at <http://www.chinainfobank.com>.

¹⁰⁸ *Id.*

available to private firms.¹⁰⁹ If a government is not pursuing the political goal of maintaining the control of the large listed companies, it is better to have a competitive takeover market where even private companies are able to join the competition of acquiring control of some large State-owned listed companies. The involvement of private companies would significantly increase opportunities for takeovers of inefficiently run State-owned listed companies.

The recent case of bidding for control of the Harbin Brewery by two foreign transnational companies on China's takeover market provides a very good example.¹¹⁰ In that case, not only was the price of the takeover fifty times the earnings of the Harbin Brewery in 2003, but the competing bidders were making a takeover bid for one hundred percent of the shares in the target company. It must be acknowledged that this is a very exceptional case. Only when the government is seriously thinking of exiting from most listed companies will the regulators pay close attention to the protection of rights and interests of minority shareholders in listed companies in China. To realize the goal of achieving efficiency through corporate law in general and takeover law in particular, the Chinese Government must abandon the concept of controlling the State-owned listed companies for the purpose of political control. Only then can the law of takeover fully realize its efficiency goal. Currently, the use of an English-type takeover law does not achieve the goal of improving the inefficiency of SOEs.

III. WEAK ENFORCEMENT OF THE LAW ON SECURITIES FRAUD

In a market economy, private companies compete for scarce financial resources. They obtain capital through retained earnings, new equity, or debt investment from the capital markets. In a relatively efficient capital market, the cost of capital formation is lower for good companies than for bad companies. Competitive discipline requires a company not to waste resources; if it wastes, retained earnings will disappear and new investment will not be forthcoming. An efficient capital market not only requires the law to deal with abuse, but also the threat of using the law must be credible.

In contrast, public enterprises do not face "hard" budget constraints.¹¹¹ Rather, governments have access to capital through their

¹⁰⁹ See Trebilcock & Iacobucci, *supra* note 9.

¹¹⁰ *The Beers Are on Anheuser*, THE ECONOMIST, June 5-11, 2004, at 56.

¹¹¹ See generally KORNAL, *supra* note 23 (discussing soft budget constraints).

taxation powers and may use those monies to fund operations, even if those operations would not survive in the private setting.¹¹² It has been pointed out that the risk of using the taxation powers is present when governments supply goods and services directly or through the vehicle of SOEs.¹¹³ The lack of discipline on SOEs in the capital market is another reason that SOEs are far less motivated and efficient than private companies.

As discussed in Part II, China's stock market was mainly designed at the beginning of the 1990s to solve the inefficiency of SOEs, which is why the State-owned listed companies dominate the two stock exchanges.¹¹⁴ This section will explain that the privilege China's SOEs enjoyed in using the stock market is another form of soft budget constraints. So long as SOEs do not have to compete with other private or foreign companies for capital on the stock market, it is unlikely that they will have the same motivation to maximize profits. When the stock market is also used politically by the government to maintain control of large SOEs in many sectors of the economy, it is unlikely that a Western-type of securities regulation will be strictly enforced. Therefore, this section will also explain that if a public framework of accountability cannot be developed to deal with abuses in public companies, it is doubtful whether such a system can be developed in a cost effective way to curb abuses in private companies on the market.

A. *Cases of Securities Fraud*

1. Chengdu Hong Guang Industrial, Ltd. ("Hong Guang")

In 1996, Hong Guang applied to the CSRC to list its shares.¹¹⁵ Despite the fact that the company suffered a loss of Rmb 103 million yuan, the company claimed that it had a profit of Rmb 54 million yuan. The company also falsified profit records in 1997 and 1998 after its shares were listed. In addition to covering the huge losses it suffered, Hong Guang used 34.3% of the capital raised in listing its shares (Rmb 140 million) to buy and sell shares on the stock market by itself and through a securities company. Because speculative trading by SOEs and listed

¹¹² See Trebilcock & Iacobucci, *supra* note 9, at 1429.

¹¹³ William Megginson & Jeffrey Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LIT. 321, 331 (2001).

¹¹⁴ See *supra* Part II.

¹¹⁵ *Penalty Decision Regarding the Violation of Securities Regulation by Chengdo Hong Guang Industrial Ltd.*, CHINA SECURITIES REGULATORY COMMISSION OFFICIAL BULLETIN 51 (Oct. 26, 1998), available at <http://www.chinainfobank.com>.

companies was prohibited,¹¹⁶ the speculative trading of shares was carried out through the opening of 228 individual trading accounts. As a matter of fact, Hong Gunag only used 16.5% of the capital raised for the projects described in its prospectus. Most of the capital raised was actually used by the company to pay its debts to banks both at home and abroad. After investigation, the CSRC confiscated Rmb 4.5 million yuan in illegal trading profits derived from speculative trading, imposed an administrative fine of Rmb one million yuan, and permanently prohibited the chairman of the board of directors, the general manager, and the deputy financial officer from assuming senior officer positions in listed companies or securities institutions. Subsequently, the Intermediate People's Court of Chengdu sentenced these three people to jail terms of three years or less.¹¹⁷ While this was the first case that criminal liability was imposed on responsible persons in listed companies, the court refused to hold a trial for the claim of civil liability. Even though the fraud would be a clear case of the tort of deceit in well developed common law jurisdictions, and civil liability can also be grounded on Article 77 of the Provisional Regulation on the Administration of Issuing and Trading of Shares¹¹⁸ and Article 63 of the Securities Law,¹¹⁹ the Court justified its decision on the ground that the loss suffered by investors was not necessarily caused by the fraud.¹²⁰

2. Energy 28

Energy 28 falsely claimed to have a profit of Rmb sixteen million yuan at the time of application for listing its shares and a total profit of Rmb 211 million yuan during the three years thereafter.¹²¹ Furthermore, the company changed the use of funds as specified in the prospectus in

¹¹⁶ *Measures Concerning the Prohibition of Speculative Trading of Shares by State-Owned Enterprises and Listing Companies*, COLLECTION OF THE LAWS OF THE PRC 498 (1997) (issued jointly by the State Council Securities Commission, the People's Bank of China, and the State Economic and Trade Commission on May 27, 1997).

¹¹⁷ Yao Bei, *Hong Guang: The First Case of Criminal Punishment*, PEOPLE NET, (Dec. 15, 2000), available at <http://www.people.com.cn>.

¹¹⁸ COLLECTION OF THE LAWS OF THE PRC 480 (1993) (promulgated by the State Council on April 22, 1993), translated in *Securities Regulations*, CHINA L. & PRAC. 23 (1993) [hereinafter *Securities Regulations*].

¹¹⁹ COLLECTION OF THE LAWS OF THE PRC 671 (1998) (enacted by the Standing Committee of the National People's Congress on Dec. 29, 1998), translated in *Securities Law*, CHINA L. & PRAC. 25 (February 1999).

¹²⁰ Yao, *supra* note 117. It is not clear whether criminal liability would have been imposed had the responsible persons not used the raised money for speculative trading (a purely personal act compared with the raising of funds for the company).

¹²¹ Luo Xiaoming, *CSRC Investigated and Punished Energy 28*, PEOPLE NET (Dec. 20, 2000), available at <http://www.people.com.cn>.

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1996 and in the documents for an additional issue of shares in 1997. As a result, the CSRC imposed an administrative fine of Rmb one million yuan on the company, Rmb fifty thousand yuan upon the chairman of the board of directors, and Rmb thirty thousand yuan upon three other directors. There were neither criminal proceedings nor civil lawsuits instituted in this case.

3. Sanjiu Medical and Pharmaceutical Co. ("Sanjiu")

During an investigation conducted by the CSRC in June 2001, the CSRC discovered that the controlling shareholder of Sanjiu improperly used a total of Rmb 2.5 billion yuan of Sanjiu funds, accounting for ninety-six percent of Sanjiu's net assets.¹²² The board of directors and the supervisory board of Sanjiu did not support the use of such a large amount of the listing company's funds by the controlling shareholder for a connected transaction. Except for a public criticism by the CSRC, however, no shareholders' action was taken against the controlling shareholder in this case. Lack of clear provisions on derivative actions by shareholders makes it very difficult for individual shareholders to sue the wrongdoers that violate provisions either in the Company Law or in the Articles of Association of Listed Companies.¹²³

4. Hubei Meierya Co. ("Meierya")

Improper use of funds by listed companies also occurred in Meierya.¹²⁴ In that case, the controlling shareholder improperly used Rmb 368 million yuan belonging to Meierya, accounting for forty-one percent of Meierya's net assets. It does not appear from the report that either the board of directors or the shareholders of Meierya authorized the use of funds.

5. Shanghai Jiabao Industrial (Group) Co. ("Jiabao")

The CSRC investigated Jiabao in August 2000. Among other violations of law uncovered by the CSRC, Jiabao engaged in illegal

¹²² *Public Criticisms by the CSRC on Three and Nine Medical and Pharmaceutical Co. Ltd. and the Relevant Persons*, (Aug. 21, 2001), available at <http://www.chinainfobank.com>.

¹²³ COLLECTIONS OF THE LAWS OF THE PRC 779 (1998) (issuing the Guidelines of Articles of Association of Listed Companies by the China Securities Regulatory Commission on Dec. 16, 1997).

¹²⁴ *Public Criticisms by China Securities Regulatory Commission on Hubei Meierya Co. Ltd. and the Relevant Persons of the Company*, (September 20, 2001), available at <http://www.chinainfobank.com>.

speculative trading of shares in other companies.¹²⁵ The investigation revealed that Jiabao injected Rmb 228 million yuan onto both the primary market and the secondary market in Shanghai. As listed companies are prohibited from speculative trading, Jiabao utilized more than three hundred individual accounts to circumvent the ban from 1996 to 1998.¹²⁶ The illegal gain from the trading of shares in other companies amounted to Rmb 840,000 yuan. Besides illegal trading of shares in other companies, Jiabao also traded the shares of its own company by using three accounts of different individuals. The investigation did not discover any illegal gain from the trading of its own shares. In that case, the CSRC imposed an administrative fine of Rmb fifty thousand yuan upon the chairman of the board of directors, confiscated the illegal trading gain of Rmb 840,000 yuan, and publicly criticized the directors of Jiabao.

6. Shandong Bohai Holding, Ltd. ("Bohai")

Bohai was a case of manipulation of the company's own shares.¹²⁷ On August 1, 1994, senior officers of Bohai engaged in repeated trading and false purchases and sales of shares of its own company without the actual transfer of title of the shares. Like the previous cases, the senior officers used the accounts in the name of four individuals. The price of Bohai shares rose 102% as a result of the market manipulation. Bohai spent Rmb 19.9 million yuan of its own funds purchasing 3,981,200 of its own shares on the Shanghai Stock Exchange.¹²⁸ Bohai eventually sold all of these shares, and, together with 845,600 shares held before August 1, Bohai had made a profit of Rmb 5.9 million yuan.¹²⁹ The CSRC discovered numerous violations of the securities regulations by Bohai and issued an official reprimand, confiscated the illegal profits, and imposed a fine of Rmb one million yuan on the company and a fine of Rmb fifty thousand yuan on Mr. Li Gang, the responsible officer.¹³⁰

¹²⁵ *Penalty Decision of China Securities Regulatory Commission Concerning the Violation of Securities Law and Regulation by Shanghai Jiabao Industrial (Group) Co. Ltd.*, CHINA SECURITIES REGULATORY COMMISSION OFFICIAL BULLETIN 36 (Oct. 8, 2000), available at <http://www.chinainfobank.com>.

¹²⁶ See *supra* note 116 and accompanying text.

¹²⁷ Philip Gregory, *Securities Fraud in the PRC*, CHINA L. & PRAC. 20, 21 (March 1995).

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

B. *Implications of the Cases*

These Chinese cases provide strong evidence that managers are not working for the best interest of the residual claimants. In the case of Hong Guang, managers cheated investors out of their money at the time of listing by falsifying profit records.¹³¹ The strategy of using a false profit record was also adopted by Energy 28 for the subsequent distribution of shares after the company had become a listed company.¹³² The controlling shareholders' abuses of the listing companies' funds in the cases of Sanjiu and Meiyera shows a lack of consideration on the part of controlling shareholders for the interest of minority shareholders.¹³³

The Chinese way of vividly describing cheating of capital suppliers by the insiders, such as managers and controlling shareholders, is "quanqian," or circling money. Using funds raised for improper purposes on the stock market, such as in the case of Jiabao, provides evidence that managers do not have good projects to efficiently use the raised capital.¹³⁴ Manipulating the shares of their own companies, in the cases of Jiabao and Bohai, indicates that managers in these companies are not using all their skills and efforts to discover net present value projects or using existing assets effectively.¹³⁵ Such straightforward cases of cheating their own shareholders are very unlikely to occur in jurisdictions where minority shareholders are well protected.

The Chinese government has tried to eliminate the problem of soft budget constraints by tightening the bank credit provided to SOEs. This attempt has created problems for mismanaged SOEs. The use of the stock market is expected to provide the necessary funds so that some symbolically-large, State-owned listed companies can survive, while being subjected to some stock market disciplines. From an agency perspective, when managers and directors in SOEs are not motivated to pursue the clear goal of maximizing profit and are not subject to hard budget constraints if their companies are efficiently run, they will seek personal gains, as demonstrated in the above cases. The cases also reveal that the political goal of maintaining some symbolically-large, listed SOEs requires the continuous supply of capital. In the past, the problem was that State-owned banks could not tighten the credit on inefficient SOEs, but the

¹³¹ See *supra* Part III.A.1.

¹³² See *supra* Part III.A.2.

¹³³ See *supra* Part III.A.3.

¹³⁴ See *supra* Part III.A.4.

¹³⁵ See *supra* Part III.A.4-5.

current problem is that the government cannot tighten the supply of capital on the stock market. If capital markets cannot penalize inefficient SOEs because of political concerns, it is unlikely that corporate law and securities regulations, including civil remedies, will be strictly enforced.

C. *Weak Enforcement of Securities Regulation*

Since the establishment of the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange in 1991, the stock market in China has developed relatively quickly.¹³⁶ By the end of 2000, there had been 1,211 corporations listed domestically and internationally.¹³⁷ In December 2000, thirty percent of corporate capital was raised on the stock market as compared with ten percent in 1993.¹³⁸ The capitalization of the stock market was fifty-seven percent of the gross domestic product,¹³⁹ which is very puzzling considering the weak protection of minority shareholders. High savings rates and a lack of alternative investment channels explains why the stock market in China can develop quickly when investors are frequently cheated. Measured by the factor of whether corporations assure a reasonable return to the suppliers of capital, the corporate governance system in China requires considerable improvements.

The weak protection of minority shareholders is caused by several factors. First, criminal prosecution is rarely instituted. The Company Law¹⁴⁰ and the Provisional Regulation on the Issuance and Trading of Shares ("PRITS")¹⁴¹ do not contain clear provisions on criminal liability for misstatements in disclosure documents. However, the *Decision on the Punishment of Crimes in Violation of the Company Law*¹⁴² provides that if a company issues shares or corporate bonds with a falsified prospectus, subscription forms, or corporate bond distribution documents, thereby

¹³⁶ Han Zhiguo, *The Development and Innovation of Shareholding Economy in China*, PEOPLE NET, (May 26, 2001), available at <http://www.peopledaily.com.cn>.

¹³⁷ Wu Feng, *Ten Questions Required Quick Solutions*, PEOPLE NET, (September 22, 2001), available at <http://www.peopledaily.com.cn>.

¹³⁸ Fang Yuan, *Zhou Xiaochuan: The Securities Market Has a Big Opera Next Year*, PEOPLE NET, (Dec. 29, 2000), available at <http://www.people.com.cn>.

¹³⁹ See Wu Feng, *supra* note 137.

¹⁴⁰ COLLECTION OF THE LAWS OF THE PRC 456 (1993) (effective July 1, 1994), translated in *Company Law*, CHINA L. & PRAC. 7, 20 (1994) (arts. 59, 51).

¹⁴¹ COLLECTION OF THE LAWS OF THE PRC 480 (1993), translated in *Securities Regulations*, *supra* note 118, at 23 (presenting the PRITS, which was issued by the State Council on April 22, 1993).

¹⁴² COLLECTION OF THE LAWS OF THE PRC 51 (1994), available at <http://isinolaw.com> (presenting the Decision, which was promulgated by the Standing Committee of the National People's Congress on February 28, 1995).

raising huge amount of capital and causing serious consequences or other serious events, the persons directly responsible will be sentenced either for a term of less than five years or subject to a criminal penalty of five percent of the amount raised, or the person will be subject to both penalties.¹⁴³ A similar provision was subsequently incorporated into the 1997 Criminal Act.¹⁴⁴ Despite such a clear provision and numerous cases of misrepresentation, the first case where criminal liability was imposed on three directors did not occur until 2000.¹⁴⁵

Second, the civil liability regime is not only poorly framed but also weakly enforced. Compared with the relatively clear provisions on criminal liability, there are only a few major provisions on civil liability. Article 77 of PRITS stipulates that “anyone who violat[es PRITS and] causes losses to others shall bear civil liability for compensation according to law.”¹⁴⁶ Since four types of misconduct are regulated by PRITS, covering misrepresentation, insider trading, market manipulation, and fraud committed by securities intermediaries against customers, it is very difficult for judges who are not sophisticated and do not have law-making power to apply such a vague provision to deal with civil liabilities when capital users or intermediaries deliberately or negligently mislead investors through disclosure documents.¹⁴⁷ Because of this difficulty in applying Article 77 of PRITS, it has not been used to hold any defendant civilly liable for misrepresentation. Likewise, the Securities Law Article 63 provides the following:

If the prospectus, documents of offer of corporate bonds, financial or accounting reports, listing documents, annual reports, mid-term reports or ad hoc reports distributed by the issuer or distributing securities company contain a falsehood, misleading statement or major omission and thereby causes investors to sustain losses in the course of securities trading, the issuer or distributing securities company shall be liable for damages and the responsible directors, supervisors and/or the managers of the issuer or distributing

¹⁴³ *Id.* art. 3(1).

¹⁴⁴ See CRIMINAL LAW OF THE PRC. art. 160 (1997).

¹⁴⁵ See *Penalty Decision Regarding the Violation of Securities Regulation by Chengdo Hong Guang Industrial Ltd.*, *supra* note 115.

¹⁴⁶ *Securities Regulations*, *supra* note 118, at 23, 42 (art. 77).

¹⁴⁷ *Id.*

securities company shall be jointly and severely liable for damages.¹⁴⁸

While Article 63 covers issuing companies and underwriters for both negligent and fraudulent statements in these relevant disclosure documents, Article 202 provides the grounds for civil liability in connection with fraudulent misstatements produced by intermediaries.¹⁴⁹ Article 202 provides, among other things, that “if a professional organization that issues documents such as audit reports, asset valuation reports or legal opinions for the issuance of or listing of securities or securities trading activities” provides false certification and causes losses to investors, the professional organization shall bear liability.¹⁵⁰ There are at least two problems with Article 202. First, fraudulent misrepresentation is difficult to prove in practice. A better approach is to hold intermediaries liable based on negligent misrepresentation. Second, there is no need to always hold the intermediaries jointly liable—they can be independently liable for their own negligence, particularly when the issuer has no fault.

Leaving aside the problems in Article 202, the civil liability for negligent misrepresentation provided in Article 63 is relatively clear. By the end of 2002, however, there had not been a single case where an issuer bore civil liability despite the large number of cases of negligent or fraudulent misrepresentation. In the Hong Guang case discussed previously, the First Intermediate People’s Court of Chengdu in the Province of Sichuan sentenced several directors to three-year imprisonments or other criminal penalties.¹⁵¹ Investors in that case also instituted civil actions, claiming damages for misrepresentation.¹⁵² The District People’s Court of Pudong, however, did not accept their cases, explaining that the cases did not fall within the scope of acceptance.¹⁵³

¹⁴⁸ COLLECTION OF THE LAWS OF THE PRC 671 (1997), translated in *Securities Laws*, supra note 66, at 37 (art. 63) (promulgated Dec. 29, 1998, effective July 1, 1999).

¹⁴⁹ *Id.* at 37 (art. 63), 64 (art. 202).

¹⁵⁰ *Securities Laws*, supra note 66, at 64 (art. 202).

¹⁵¹ See *Penalty Decision Regarding the Violation of Securities Regulation by Chengdo Hong Guang Industrial Ltd.*, supra note 115.

¹⁵² The first person to bring a lawsuit was Jiang. Huang Xiangyuan, *Hong Guang Qizha An Mei Namu Rongyi Wanjie (The Case of Fraud of Hong Guang Could Not Easily Be Ended)*, SEC. NEWSPAPER, (Dec. 28, 2000), available at <http://www.people.com.cn/GB/channel3/24/20001228/365000.html>.

¹⁵³ *Id.*

Civil lawsuits were also instituted in several courts in the similar case of *Yin Guang Xia*.¹⁵⁴ Whereas many courts refused to accept cases of misrepresentation, a court in Wuxi originally planned to entertain a similar lawsuit.¹⁵⁵ Shortly after the Wuxi court accepted the case, the Supreme People's Court instructed all courts not to accept civil cases related to securities fraud, insider trading, and market manipulation.¹⁵⁶ Upon receiving the Notice, the Wuxi Court suspended the treatment of the case.

The Notice of the Supreme People's Court invited a great deal of criticism.¹⁵⁷ Four months later, the Supreme People's Court circulated another notice to the lower courts, instructing them to accept civil suits related to misrepresentation in disclosure documents.¹⁵⁸ In this subsequent Notice, the Supreme People's Court conditioned the acceptance of civil lawsuits upon investigation and punishment of the wrongdoer by the CSRC.¹⁵⁹ Further, the Supreme People's Court stated that no class action should be allowed.¹⁶⁰ Although the Supreme People's Court subsequently issued a relatively detailed judicial opinion, as of May 2004, there had been no court judgment requiring an issuer with securities fraud to pay large sums of damages to a large number of small investors.¹⁶¹

In addition to the weak enforcement of criminal and civil provisions, lack of shareholders' remedies is another factor contributing to the weak corporate governance system in China. Neither the Company Law nor

¹⁵⁴ Xue Li, *Cong Hong Guang Dao Yin Guang Xia, Minishi Peichang De Lu You Duochang* (From Hong Guang Dao Yin Guang Xia, How Far We Still Have to Go for Civil Compensation), SHANGHAI SEC. NEWSPAPER, (Sept. 6, 2001), available at <http://finance-sina.com.cn>.

¹⁵⁵ Tao Feng, *Cong Hong Guang Dao Yin Guang Xia Kan Gumin Weiquan* (Look at the Protection for Investors from Hong Guang to Yin Guang Xia), (Sept. 28, 2001), available at <http://www.people.com.cn/GB/jinji/36/20010928/571634.html>.

¹⁵⁶ Notice of the Supreme People's Court Concerning the Temporary Non-Acceptance of Securities Cases for Civil Compensation, (Sept. 21, 2001), available at <http://www.chinainfo bank.com>.

¹⁵⁷ Ji Wenhai, *Zhongguo Remmin Daxue Sanwei Jiaoshou Tan Zhengquan Weifa Ji Chengzhi* (Three Professors Talked about Violation of and Punishment for Illegal Acts on the Securities Markets), CHINESE ECON. TIMES, (Oct. 17, 2001), available at <http://www.chinainfobank.com>.

¹⁵⁸ Notice of the Supreme People's Court on Certain Issues Concerning the Acceptance of Tort Cases Involving Misrepresentation on the Securities Market, (January 15, 2002), available at <http://www.chinainfobank.com>.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ Trial of Civil Damages Cases Arising from Misrepresentation in the Securities Market Several Provisions, CHINA L. & PRAC. 53 (2003) (issued by the Supreme People's Court on Jan. 9, 2003, effective Feb. 1, 2003).

the Securities Law contain any provision giving the shareholders the right to bring derivative actions against corporate directors or managers for their wrongful activities. Evidence in the United States “shows that lawsuits are more common in firms more likely to need monitoring . . . and that the probability of CEO turnover rises after a lawsuit is filed.”¹⁶²

Japan’s experience is also helpful. According to Michael Gibson, the Assistant Director of the Federal Reserve Board, “[i]n October 1993, Japan’s Commercial Code was revised to reduce the fees required to file a derivative lawsuit.”¹⁶³ Since then, derivative lawsuits have increased five times.¹⁶⁴ These suits have heightened Japanese managers’ awareness of their duties to corporations and their shareholders.¹⁶⁵ Law reform in China is also necessary in order to facilitate shareholder derivative actions, particularly when most of the listing companies in China are majority-controlled. Among the 1124 listed companies in April 2001, seventy-nine percent were controlled by a shareholder who owned more than fifty percent of the shares.¹⁶⁶ In sixty-five percent of the listed companies, State shareholding dominated.¹⁶⁷ This level of control further indicates that insiders control most of these listed companies. Without the threat of derivative actions, the protection of minority shareholder interests is unlikely.

Still another factor contributing to the weak protection of minority shareholders is the low quality of certification by intermediaries. When companies that raise capital cannot be trusted, third party certification plays important roles in solving the adverse selection problem.¹⁶⁸ Third parties would include investment banks, accounting firms, and securities counsel.¹⁶⁹ The principal role of securities intermediaries is to vouch for

¹⁶² Michael Gibson, “Big Bang” *Deregulation and Japanese Corporate Governance: A Survey of the Issues*, in *CRISIS AND CHANGE IN THE JAPANESE FINANCIAL SYSTEM* 291, 305 (Takeo Hoshi & Hugh Patrick eds., 2000) (citing PHILIP STRAHAN, *SECURITIES CLASS ACTIONS, CORPORATE GOVERNANCE AND MANAGERIAL AGENCY PROBLEMS* (Federal Reserve of New York, Working Paper, 1998); see also The Federal Reserve Board, *Michael S. Gibson*, at <http://www.federalreserve.gov/research/staff/gibsonmichaels.htm> (last visited Feb. 15, 2005).

¹⁶³ Gibson, *supra* note 162, at 305.

¹⁶⁴ Curtis Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145, 1188 (1998).

¹⁶⁵ *Id.*

¹⁶⁶ Wu Feng, *supra* note 137.

¹⁶⁷ *Id.*

¹⁶⁸ See George Akerlof, *The Market for “Lemons”: Quality Uncertainty, and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

¹⁶⁹ Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 788 (2001).

disclosure quality and thereby reduce information asymmetry in securities markets.¹⁷⁰ The system of third party certification works well, however, only when the securities intermediaries are subject to constraints. Some of the constraints include self-regulation, licensing systems, civil liability to investors, and criminal liability.

The role of self-regulatory organizations in China is currently too weak to curb serious securities fraud. However, the licensing system, administered by the CSRC, works better in China. For securities companies, including investment banks, a license from the CSRC is required.¹⁷¹ Qualified accounting firms still need a license jointly issued by the CSRC and the Ministry of Finance in order to do securities related accounting.¹⁷² During the last several years, the CSRC has suspended the licenses of and penalized many securities companies and accounting firms.¹⁷³ Due to the limited resources of the CSRC, however, many wrongdoers are unlikely to be caught. Under these circumstances, criminal and civil liability are needed to deter false certification.

By the end of September 2002, there had not been a single case where an accounting firm or underwriter had been subject to criminal liability. As far as civil liability is concerned, holding accounting firms liable requires fraudulent misrepresentation.¹⁷⁴ Since it is difficult to prove the intention of cheating, imposing civil liability on accounting firms will be very difficult. Although it is relatively easy to catch securities underwriters committing negligent misrepresentation, or making important omissions that give rise to civil liability, there is not a single case where a securities underwriter has been sued. The logic is simple. If issuers have rarely been held liable for the losses suffered by hundreds of thousands of investors, how can securities underwriters be held civilly liable for these losses? When securities intermediaries are not subject to adequate constraints, the role of third party certification is considerably weakened.

¹⁷⁰ *Id.*

¹⁷¹ COLLECTION OF THE LAWS OF PRC (1998) (arts. 117, 119) (enacted by the Standing Committee of the National People's Congress on Dec. 29, 1998), *translated in Securities Law*, CHINA L. & PRAC. 25 (February 1999).

¹⁷² *Notice Concerning the Qualification of Auditing Firms for Securities Business Issued by China Securities Regulatory Commission and the State Administration of Auditing on March 23*, SELECTED SECURITIES LAWS AND REGULATIONS 893 (1993) (Shanghai University of Finance and Economics, 2002) (arts. 2, 3).

¹⁷³ The penalty decisions can be found in the Official Bulletin of China Securities Regulatory Commission in various years.

¹⁷⁴ *Securities Laws*, *supra* note 66, at 64 (art. 202).

Part II of this Article has pointed out that China's stock market and the applicable laws were initially designed to improve the inefficient SOEs.¹⁷⁵ If at the time of enterprise reform various governments knew that the SOEs were not efficiently managed and yet they urged these enterprises to go to the stock market for capital, it is unlikely that violations of imported, Western-type, securities regulations will be heavily penalized. Strict enforcement of civil liability provisions is inconsistent with the political goal of maintaining some symbolically-large SOEs in key sectors of the economy as many SOEs would be denied the benefit of using the supply of capital on the stock and became bankrupt. This explains the phenomenon of soft budget constraint on China's capital market. It also partly explains the weak enforcement of the law, which is a cause of the defect of market institutions.

D. A Public Framework of Accountability

While recognizing the benefits of privatization, Professor Martha Minow has also pointed out some concerns.¹⁷⁶ One of the concerns is that "privatization can undermine a value as basic as guarding against the misuse of public funds."¹⁷⁷ According to Minow, "a shifting mix of public and private providers of education, welfare, and prison services" requires a system of public accountability:

Privatization of public services soared precisely when major corporations engaged in unfettered private self-dealing and one major religious group reeled from scandals, cover-ups, and mounting distrust among the faithful. The coincidence in timing should be all the reminder anyone needs of the vital role of public oversight and checks and balances.¹⁷⁸

Professors Trebilcock and Iacobucci have already pointed out the fundamental problem with Minow's article.¹⁷⁹ Their view is that it is inadequate to move "directly from making observations about flaws in

¹⁷⁵ See *supra* Part II.

¹⁷⁶ Martha Minow, *Public and Private Partnerships: Accounting for the New Religion*, 116 HARV. L. REV. 1129, 1249-55 (2003) (discussing privatization in the context of the U.S. educational system).

¹⁷⁷ *Id.* at 1247.

¹⁷⁸ *Id.* at 1259-60.

¹⁷⁹ See Trebilcock & Iacobucci, *supra* note 9, at 1422.

private markets to drawing conclusions about the importance of maintaining public sector influence in various settings.”¹⁸⁰

The cases discussed in this section provide an interesting test ground. If a public framework of accountability works well, such a system should be relevant to Chinese SOEs in which governments are heavily involved. In the context of China, a public framework of accountability does not work well or cannot be easily established. As most listed SOEs in China only provide non-public goods, it is unnecessary to discuss in detail non-instrumental values like democracy, equality, and pluralism.

Accountability in the public framework means being “answerable to authority that can mandate desirable conduct and sanction conduct that breaches identified obligations.”¹⁸¹ More specifically, accountability includes the use of contracts when working with private enterprises to deliver social services.¹⁸² At a minimum, “[a] public framework of accountability for these activities would disclose the facts surrounding the contracting process to the public.”¹⁸³

The distribution of shares of SOEs in China involves (1) contractual arrangements with intermediaries and (2) disclosure of underwriters and the nature of the issuers. In order to issue shares to the public, issuers are required to contract with accounting firms and securities companies, both of which are mainly SOEs. When acting as securities underwriters, “securities companies must examine the truthfulness, accuracy and completeness of the public offer documents If they find that such documents contain any falsehoods, misleading statements or major omissions, they may not carry out the sales activities.”¹⁸⁴ Issuers are also required by contract to get accounting firm verification of the financial and accounting reports of the company for the last three years.¹⁸⁵ Furthermore, issuers must disclose detailed information about themselves to the CSRC and the public.¹⁸⁶ Securities fraud in disclosing false or misleading information to the public persists despite these contractual arrangements and legal requirements.

¹⁸⁰ *Id.*

¹⁸¹ See Minow, *supra* note 176, at 1260.

¹⁸² *Id.* at 1267.

¹⁸³ *Id.*

¹⁸⁴ *Securities Law, supra* note 66 (art. 24).

¹⁸⁵ *Id.* (art. 45).

¹⁸⁶ *Id.* (arts. 45, 47).

Minow's second model of public accountability imposes constitutional obligations on the government.¹⁸⁷ In the least, these "constitutional values are meant to guard against self-dealing or other conflicts of interest that arise when private parties are entrusted with public duties."¹⁸⁸ As part of the provisions of non-public goods or services carried out by SOEs in China, various rules against self dealing or other conflicts of interest are available. These rules include party discipline and criminal and civil liability. Party rules require that members of the Chinese Communist Party ("CPC") shall not seek special interests or privileges except within the scope of law or policy.¹⁸⁹ Violations of CPC rules may result in a warning, serious warning, removal of position within the CPC, putting the violator onto a monitoring list while keeping CPC membership, or expelling the violator from the CPC.¹⁹⁰ In a country always ruled by one party, the loss of party membership is a significant and real burden. In addition, criminal law penalizes misconduct of managers and directors related to bribery,¹⁹¹ competition with the company,¹⁹² and seeking self interest or interest for friends.¹⁹³ Moreover, Company Law also prohibits or restricts self-dealing or conflicts of interest transactions.¹⁹⁴ Despite all these rules, connected transactions between parent companies and subsidiaries or between associated companies of SOEs are very frequent, harming the interest of minority shareholders. Statistics show that 84.6% of the listed companies carried out connected transactions in 1997.¹⁹⁵ While seeking personal gains in conflicts of interest transactions will be heavily penalized, connected transactions between associated companies of SOEs rarely attract legal liability.¹⁹⁶ This situation again shows the failure of public accountability as it relates to public involvement in the provision of goods and services in China.

¹⁸⁷ Minow, *supra* note 176, at 1267.

¹⁸⁸ *Id.* at 1268.

¹⁸⁹ Zhong Guo Gong Chun Tong Zhang Cheng, *Articles of Association of the Chinese Communist Party*, art. 2.

¹⁹⁰ *Id.* (art. 39).

¹⁹¹ CRIMINAL LAW, *supra* note 144, art. 163 (1997).

¹⁹² *Id.* art. 165.

¹⁹³ *Id.* arts. 166, 168.

¹⁹⁴ *Company Law*, CHINA L. & PRAC. 7 (March 1994) (arts. 59, 61).

¹⁹⁵ Zhu Baoxian & Miu Haiying, *A Preliminary Discussion of Connected Transactions in Chinese Listed Companies*, 18 ECON. MGMT. (2001), available at <http://www.e521.com>.

¹⁹⁶ See, e.g., Kingsley T.W. Ong & Colin R. Baxter, *A Comparative Study of the Fundamental Elements of Chinese and English Company Law*, 48 INT'L & COMP. L. Q. 88, 121 (1999).

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A third model of accountability advocated by Minow is administration.¹⁹⁷ While it is not easy to specify the content of administration, the term requires the collection of information so that providers of goods or services can be properly chosen, assessed, and monitored.¹⁹⁸ The case of China shows that Minow's approach is unlikely to succeed. To ensure the quality of the issuers and to control development of the stock market, the Chinese Government specified a quota for the distribution of shares by issuers in China in the early and middle 1990s.¹⁹⁹ To get a quota, potential issuers had to apply to provincial governments or ministries under the State Council for approval.²⁰⁰ The locally selected companies had to obtain further approval from the CSRC, which also consulted the then State Economic and Trade Commission and the State Development and Planning Commission.²⁰¹ Despite the heavy involvement of various government agencies, abuse of the process was widespread as discussed in the early part of this section.

The fourth legal model for public accountability advocated by Minow is democracy.²⁰² According to Minow, "Democracy involves both the processes and values committed to governance by the people."²⁰³ Minow further asserts that "[d]isclosure of relevant information, accompanied by periodic occasions for the expression of public views on [certain] decisions and the standards set and used to assess them, would" enhance democratic values.²⁰⁴ While China has never adopted any Western democratic form of government, the concept and system of socialism reflects a value of rule by the people. In a rigid socialist country, the means of production were all in the hands of the State. Employees or people in general were the masters of enterprises and the country. Rational passivity and free rider problems, however, led people to the direction of irresponsibility. The vehicle of SOEs was originally intended to better serve the people who were the residual

¹⁹⁷ Minow, *supra* note 176, at 1268.

¹⁹⁸ *Id.*

¹⁹⁹ CSRC, *The CSRC Notice of Opinions on the Administration of Certain Issues Concerning the Issuing of Shares* (Oct 24, 1995), available at <http://www.chinainfobank.com> (providing brief information on the quota system).

²⁰⁰ *Checking and Approval Procedure of the China Securities Regulatory Commission on the Issuing of Shares*, § 1, at 177, COLLECTION OF SEC. L. AND REGS. (Mar. 16, 2000).

²⁰¹ *Id.* § 2.

²⁰² Minow, *supra* note 176, at 1268-69.

²⁰³ *Id.*

²⁰⁴ *Id.* at 1269.

claimants of SOEs. The reality, however, did not properly reflect the socialist ideal.

Widespread securities fraud in China's listed SOEs reveals the failure of the system of public accountability. It is puzzling why a public framework of accountability along the line advocated by Minow does not work in China or cannot be developed to better deal with the waste of public resources in SOEs. Trebilcock and Iacobucci doubt whether public accountability mechanisms work to discipline public actors.²⁰⁵ They conclude that the features that undermine the market often undermine public provision of goods or services as well.²⁰⁶

If a public framework of accountability does not work well in the case of public provision of goods by using the vehicle of SOEs, it is doubtful whether such a public framework works to discipline private actors. At least, "the imposition of legal accountability or other constraints on the private sector may entail costs in terms of reduced competition, innovation, and flexibility, which may negate any advantages of private sector over public sector provision."²⁰⁷

IV. CONCLUSION

This Article uses the example of takeovers and securities fraud to examine why the imported, Western-style of takeover law or securities regulation cannot be fully enforced in China. The political goal of maintaining the control of a large number of State-owned listed companies appears to be a significant contributing factor to why China cannot fully utilize the benefits of Western law in the establishment of a market-oriented economy. If China wants to successfully compete in a globalized economy, the Chinese government has to seriously consider the issue of whether it should withdraw or considerably reduce the ownership in the large number of State-owned listed companies. The two examples can be extended to other areas to show that the institutional defects in State-owned companies do not provide adequate means to motivate managers and directors in these companies to work for the best interest of their companies or adequate means to discipline the managers and directors if they do not work for the best interest of the companies they serve. During the transition from a planned economy to a market-oriented economy, corporate governance matters, particularly

²⁰⁵ Trebilcock & Iacobucci, *supra* note 9, at 1448.

²⁰⁶ *Id.* at 1436.

²⁰⁷ *Id.* at 1451.

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after China's accession to the World Trade Organization, within which China has to compete with other developed nations under similar background rules.