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A Comparative Study from the Path Dependency Theory

UNDERSTANDING CHINA’S TAKEOVER REGULATIONS

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PhD in Law

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Statement

I hereby declare that this thesis has not been and will not be, submitted in whole or in part to another University for the award of any other degree. However, the thesis incorporates to the extent indicated below, material already submitted as part of required coursework and/or for the degree of:

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Signature: ........Chuanman You............................................................
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Working Rules for Expert Consultancy Committee of Merger and Restructuring of Listed Companies (The CSRC [2012] No. 2)
Abstract

In comparative governance research, “the end of history” theme has pointed to the convergence of, *inter alia*, ideology, polity, and economic systems across the world. A similar proclamation has been advocated as “the end of corporate law” in the comparative corporate governance field. Nevertheless, the law of the takeover market, an essential part of external corporate governance, has a documented feature of regulatory heterogeneity among developed economies, such as the United Kingdom and the United States.

This thesis contributes the comparative governance research by expanding the comparative takeover law analysis into one of the major emerging markets. This research serves a two-fold purpose. The first purpose is to investigate the state of the art: the features of the pattern of the takeover regulatory regime in China, as compared to two other economics, the UK and US; the second purpose is to identify the underlying forces contributing to the multiple equilibria of regulatory regimes over takeover markets. To achieve these purposes, the author applies an enhanced theory of path dependency as the analytical framework, which reconciles the legal origins literature and the political economy literature.

The enhanced theory of path dependency includes three fundamental elements: the existence of multiple equilibria of takeover regulations, sensitive dependence on original legal conditions, and reinforcing effects by political economy constraints. Structured along with these elements, this thesis advances three main arguments:

1. Multiple equilibria: law and regulations have presented heterogeneous regulatory patterns in takeover markets of China, the UK and the US.
2. Initial conditions: heterogeneous regulatory regimes are dependent on the origins of the general legal system and corporate regulations in each country.
3. Reinforcing mechanisms: the regulatory heterogeneity contingent upon initial conditions is entrenched by each country’s unique political economy constraints.

As a conclusion, this thesis confirms the path dependent development in one of the key fields of comparative corporate governance. The conclusion of the convergence or divergence debate is inconclusive; a clearer answer is feasible for the particular area under examination. Comparative takeover law provides an example of the anti-
convergent, if not divergent, phenomenon within comparative governance research. This research also projects that the enhanced path dependency theory can be a useful analytical framework for other fields of law and development research.
Chapter 1: Introduction

The primary ambition of this thesis, building on existing literature, is to (1) establish a comprehensive path dependency theory which incorporates and reconciles the legal origins and political economy literature on law and development; (2) to apply this comprehensive theory in order to investigate the underlying factors causing the heterogeneous regulatory equilibria in three major jurisdictions.

The first section refers to the so-called “End of History” idea as the research background. The “End of History” idea proposes that a certain type of social system\(^1\) would triumph over its competitors and become the final form of human government, hence the end-point of humanity’s social evolution. A consortium of driving forces including the technology development, economic progress, and globalization could have all contributed to the consensus.\(^2\)

The second section introduces the subject of this research: the validity/invalidity of the “End of History” idea in the sphere of takeover regulations; and more importantly, how to explain its validity/invalidity? The Chinese regulatory regime has featured distinguished characteristics as compared to regulatory regimes in other main jurisdictions, such as the UK and the US.\(^3\) For the purpose of explaining the persistent existence of multiple regulatory equilibria, a path dependency theory is introduced as the analytical framework.

The third section identifies the main contributions to the literature by undertaking this research project. One the one hand, this research extends the focus of current comparative takeover regulation studies from the main developed jurisdictions to one of the major emerging markets. On the other hand, this research enriches the analytical approaches in explaining regulatory variety by profoundly engaging in the path dependence theory.\(^4\) Certain policy implications could be also drawn from understanding the root causes of heterogeneous regulation systems over a critical area of corporate governance.

\(^1\) Here the social system could be a political system, a legal system, or an economic system.


\(^3\) The hostile takeover regulatory regime in UK also distinguishes itself from that in the US. See further in the following sections.

\(^4\) See further in the Section 1.3
The fourth section explains the methodologies applied to undertake the research. The last section presents the chapter outline.

1.1 Research Background

The “End of history” idea, although hardly a novel one, has generated an ongoing tide of thought in the social science scholarship since the publication of Fukuyama’s series of “End of History” research from 1989. Upon the collapse of the Soviet Union and the end of the Cold War, Fukuyama concludes that liberal democracy has triumphed over the competing social systems such as hereditary monarchy, fascism, and communism history. Hence a “remarkable consensus” has been reached, such that liberal democracy represents the “end point of mankind’s ideological evolution” and the “final form of human government”, and, as such, constitutes the “End of History”:

What we may be witnessing is not just the end of the Cold War, or the passing of a particular period of post-war history, but the end of history as such: that is, the end point of mankind’s ideological evolution and the universalization of Western liberal democracy as the final form of human government.

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5 The similar idea could be traced back to the directional history concept of mankind’s development towards an end point of peace, prosperity and freedom. See further in Howard Williams, David Sullivan and E. Gwynn Matthews, Francis Fukuyama and the End of History (University of Wales Press 1997)

6 Fukuyama himself has also attribute the “End of History” idea to many greatest thinkers, including Immanuel Kant, Georg Wilhelm Friedrich Hegel, Karl Marx, and Alexandre Kojève. See, e.g., Fukuyama, ‘The End of History?’ (1989) 16 The National Interest 3 Francis Fukuyama, The End of History and The Last Man (Free Press 1992)


8 The logic of modern science and the struggle for recognition constituted as two mechanisms to explain the triumph of the liberal democracy as a system of government against such rival ideologies as hereditary monarchy, fascism, and communism. Fukuyama, The End of History and The Last Man (Free Press 1992)

9 As a consequence, there would be no further progress in the development of underlying principles and institutions, because all of the really big questions had been settled. Ibid Page xii


It is not hard to imagine that these hyperbolic promulgations could stir up fierce debates or critiques. For example, it is suggested that Fukuyama’s “End of History” idea fails to take into account sufficiently the facts impeding the triumph and the spread of liberal democracy such as the differences in culture, the power of ethnic loyalties and religious fundamentalism. Huntington indicates that, although the conflict between ideologies has indeed ended upon the end of the Cold War as proposed by Fukuyama, the conflict between civilizations has appeared as another phase in the evolution of conflict in the modern world hence the argument of the “End of History” suffers fallacies.


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11 One of the powerful examples is that of Islamic fundamentalism, or radical Islam. For example, after the 9/11 attacks, Fareed Zakaria called the events “the end of the end of history”, while George Will wrote that history had “returned from vacation”. Cited by Fukuyama, ‘History Is Still Going Our Way: Liberal Democracy will Inevitably Prevail’ Wall Street Journal (2001, Friday, October 5) <http://englishmatters.gmu.edu/issue6/911exhibit/emails/fukuyama_wsj.htm>
12 The stage of the conflict of ideologies is preceded by earlier stages such as the conflicts of princes and nation states. Samuel P. Huntington, ‘The Clash of Civilizations?’ (1993) 72 The Foreign Affairs 22
13 According to Huntington, a civilization is a cultural entity. It constitutes the highest cultural grouping of people. As Huntington summarizes, there are six or seven major cultural groups coexisting without converging toward any universal one in the modern world mired in a clash of civilizations.
14 Fukuyama acknowledges the existence of conflicts of cultures, but he still argues that:
15 We remain at the end of history because there is only one system that will continue to dominate world politics, that of the liberal-democratic West.
16 The Beijing Consensus was coined by Joshua Cooper Ramo in 2004 when he published the paper, “The Beijing Consensus: Notes on the New Physics of Chinese Power”, through the United Kingdom’s Foreign Policy Centre. The paper is available at: http://fpc.org.uk/fsblob/244.pdf, last accessed on 20 November 2014. As Ramo suggests: What is happening in China at the moment is not only a model for China, but has begun to remake the whole landscape of international development, economics, society and by extension, politics.
17 Ibid, Page 3. See also: Stefan A Halper, The Beijing Consensus: How China’s Authoritarian Model will Dominate the Twenty-First Century (Basic Books 2010)
“Beijing Consensus” challenges the contrasting so-called “Washington Consensus”. The “Washington Consensus” propounds the idea of “economic liberalization and political democratization”, hence it represents the liberal democracy system: the “final form of human government” as suggested by Fukuyama. While the “Beijing Consensus” features, inter alia, “State Capitalism and Authoritarianism”.

1.2 Research Subjects

The discussion of the “End of History” idea has also spread to the comparative corporate governance scholarship. As acknowledged by Hansmann and Kraakman, two leading proponents of the theme of “end of the history for corporate law”, “[O]ne’s faith in reaching the End of History for corporate law may be closely tied to one’s faith in achieving Fukuyama’s original “End of History” in politics.”

Hansmann and Kraakman suggest that the standard shareholder-oriented corporate governance model would triumph over other principal competitors, which include the Manager-Oriented Model, the Labour-Oriented Model (or stakeholder models in

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23 The shareholder-oriented model has four principal elements: (1) the shareholders retain the ultimate control over the firms and the managements operates for the interests of the shareholders; (2) interests of other corporate constituencies are protected through contractual and regulatory means instead of participation into the corporate governance; (3) interests of minority shareholders shall be protected from the exploitation of controlling shareholders; (4) interests of shareholders are principally measured by the share market value. Ibid.
general), and the State-Oriented Model. The triumph of the shareholder primacy ideology could be attributed to the failure of the alternative models, the competitive pressures of global commerce and the shift of interest groups influence favouring an emerging shareholder class. As a result, “the triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured.”

Similarly to Fukuyama’s “End of History” proclamation, Hansmann and Kraakman’s “End of History for Corporate Law” idea has also attracted voluminous debate as to its validity. Many opponents have pointed out that various impeding forces would render the “End of History for Corporate Law” idea invalid, both in theory and in reality. According to a recent comprehensive survey by Yoshikawa and Rasheed, the accumulated theoretical/empirical studies on this debate from diverse disciplines, however, provide only limited evidence to support the “End of History” predictions, i.e., one particular model would become the final form of corporate governance.

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23 Two other potential driving forces include: explicit efforts at cross-border harmonization and corporate charter competition among jurisdictions. See further on Hansmann and Kraakman, ‘The End of History for Corporate Law’ (2001) 89 The Georgetown Law Journal 439

24 Ibid

25 This conclusion, however, has been modified under their recent reflection, which puts as follows:

We always believed that ownership structures were partly endogenous and partly responsive to the larger economic world in which they were situated. Our point was that the SSM was adaptable to all ownership structures, as long as shareholders as a class enjoyed identical claims on firm cashflows. Thus, non-exploitative, regulated controlling shareholder structures fell well within the Standard Shareholder-oriented Model (SSM). Nevertheless, their reflection still asserts that:

What seemed to be obvious to us at the time and still seems obvious today: The SSM is the dominant ideology, or global normative standard, of corporate governance in this period, and is likely to remain so absent a cataclysmic event that reverses the economic progress of globalization.


27 Yoshikawa and Rasheed provide an illustrative listing of the various dimensions of convergence that have been examined in the literature. Yoshikawa and Rasheed, ‘Convergence of Corporate Governance: Critical Review and Future Directions’ (2009) 17 Corporate Governance: An International Review 388
Instead, the dynamic interplay between the driving forces and impeding forces would be more likely to generate different types of hybrid models, contingent on the internal and external environment of a particular jurisdiction. Following this observation, this thesis endeavors to examine from a comparative perspective the status quo of a key area of corporate governance, the takeover market and its regulation, by studying one particular jurisdiction, China, in a comparative perspective. It then looks into the underlying dynamics that shape the current pattern of China’s takeover regulations. A case study of the Chinese takeover regime not only contributes to the “End of History for Corporate Law” quest but also sheds light on the recent Chinese Consensus discussions and the “End of History” idea as proposed by Fukuyama.

1.2.1 The Disputable Effects of the Takeover Market

On one side, a takeover market has been praised as one of most critical corporate control mechanisms to tackle the agency problem, to increase the interests of target shareholders, to promote corporate governance and social welfare. The underlying reason comes mainly from its presumed role in the increase of market efficiency by, inter alia, disciplining underperforming management; creating synergies among merging firms; facilitating the reallocation of scarce social resources to the most efficient utilizers.

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29 Other potential contributions of undertaking such a research are provided in the following section.
On the other side, a fiercely contested takeover market can be highly controversial. Several problems can be pronounced in a takeover battle, including the information asymmetries problem, the collective action problem, and other complex relationships among bidders, target shareholders, and target managers. The market for corporate control hence could be detrimental to the interests of shareholders as a whole by, *inter alia*, impairing firms’ commitment to long-term relationships with important stakeholders; being driven by the incentive of empire building by bidder managers; causing wealth transfer among different constituencies rather than wealth creation for shareholders.

Therefore, the impact of the takeover market is an empirical question. Whether the result is positive or negative would largely depend on the property of the particular transactions involved. Regulations of the takeover market should provide mechanisms to protect the shareholder interests and to enhance the aggregate social welfare. The optimal regulations should facilitate transactions that increase shareholder value while

33 The board is assumed to be better informed than shareholders of both the target’s business and the bidder’s prospects for the target company. Martin Lipton, ‘Twenty-Five Years After Takeover Bids in the Target's Boardroom: Old Battles, New Attacks and the Continuing War’ (2005) 60 Business Lawyer 1369; Coffee, ‘Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance’ (1984) 84 Columbia Law Review 1145; Mike Burkart, ‘Economics of Takeover Regulation’ (1999) 99 SITE Staff Paper Available at: http://www2hhsse/Personal/MikeBurkart/papers/w_p5pdf
34 Since dispersed shareholders of listed company are generally too numerous and lack of coordination. Nevertheless, institutional investors recently, especially hedge funds, have been found playing critical and active, if not aggressive, role in both corporate governance and corporate control. See for example: Marcel Kahan and Edward B. Rock, ‘Hedge Funds in Corporate Governance and Corporate Control’ (2007) 15 Journal of Corporate Finance 254
preventing the management from acting against the interests of shareholders, should discourage deals that destroy shareholder value while protecting the interests of minority shareholders from controlling shareholders, and protecting the interests of external stakeholders from insiders.  

1.2.2 The Diverse Regulatory Regimes of Takeover Markets

A regulatory regime constitutes three components: the regulation framework, by which the structure of regulatory institutions and the source of substantive rules are prescribed; the regulatory institution, on which the regulatory powers are shed; the substantive rules, with which the involved parties should comply. The existing regulatory regimes governing takeover markets features heterogeneous patterns across the globe.

For the first component of the regulatory system, both specific rules and general corporate/securities law have been utilized as the source of takeover law. The balance between various sources of law varies considerably across countries. China has established a set of regulation frameworks which feature a patchwork of specific administrative regulations issued by administrative departments. Among others, the predominant source of law is the administrative regulation: The Administrative Measures for the Takeover of Listed Companies (The Takeover Measures), as promulgated by the China Securities Regulatory Commission (CSRC).

The regulation framework in China contrasts with those in other jurisdictions. In the UK, the source of the takeover law is essentially an exhaustive self-regulatory code, namely the Takeover Code (Code). In contrast, although the federal law (The William Act 1968) and the State statutes (The State Anti-Takeover Statutes) in the

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41 The Administrative Measures for the Takeover of Listed Companies was firstly promulgated in 2002, and amended in the following years of 2006, 2008, 2012 and 2014.
42 The Takeover Code, also named as the City Code on Takeovers and Mergers (the “Code”), has been developed since 1968 as non-statutory rules. But following the implementation of the Takeovers Directive (2004/25/EC) by means of Part 28 of the UK Companies Act 2006, the Code has now gained a statutory basis. It has been constantly amended by The Code Committee of the Panel as a reflection to the changing legal and business practice. The most recent amendment was released on 14/11/14 and will become effective as of 01/01/15. See further discussion in chapter 2.
43 Incorporated into the Section 13 and the Section 14 of the Securities Exchange Act of 1934, the William Act is also called after the long title as: An Act Providing for Full Disclosure of Corporate Equity Ownership of Securities under the Securities Exchange Act of 1934. Further discussion is presented in following chapters. See
US prescribe certain rules to regulate takeover transactions, the case law developed in the State of Delaware constitutes the predominant source of takeover law.\textsuperscript{45} For the second component of the regulatory regime, a ministry-level administrative institution, i.e., the China Securities Regulatory Commission (CSRC), has been heavily involved in the governance of the market for corporate control in China. The CSRC has both the power to promulgate and to enforce the takeover rules.\textsuperscript{46} In contrast, the UK Takeover Code has been administered by the Takeover Panel (Panel). The Panel is an independent autonomous regulatory body appointed by entities representing different segments of the British financial community.\textsuperscript{47} The Delaware case law is predominantly developed by the justices from the Delaware Court of Chancery and the Delaware Supreme Court.\textsuperscript{48}

The different natures of these regulatory institutions determine the different approaches in the supply and enforcement of takeover rules.\textsuperscript{49} The nature of CSRC as an administrative department renders the takeover regulations in China subject to the pervasive governmental intervention. The UK Takeover Panel as an autonomous body is vulnerable to the influence of market participants especially the powerful institutional investors; the US state judicial branch creates a common law system which is influenced by the management group.\textsuperscript{50} For the third component of the regulatory regime, the diversity of substantive rules becomes even more dramatic, particularly the rules regarding takeover defensive

\textsuperscript{44} The State Anti-takeover Statutes refer to the legislation promulcated by States for the purpose of preventing or deterring hostile takeovers targeting the companies incorporated within the States. The provisions provided in these legislation vary across different States and different time periods. Further discussion is presented in following chapters. See also Michal Barzuza, ‘The State of State Antitakeover Law’ (2009) 95 Virginia Law Review 1973 Emiliano Catan and Marcel Kahan, ‘The Law and Finance of Antitakeover Statutes’ 68 Stanford Law Review 629

\textsuperscript{45} Further discussion is presented in following chapters, see also Reinier Kraakman and others, The Anatomy of Corporate Law: A Comparative and Functional Approach (2 edn, Oxford University Press 2009) Page 231

\textsuperscript{46} Article 7, Securities Law of the People’s Republic of China.

\textsuperscript{47} The Companies Act 2006, implementing Takeover Directive 2004, also provides Chapter 28 to regulate the takeovers. Nevertheless, it is mainly to ascertain the function of the Panel as an independent body to enforce the Takeover Code. Further discussion on this matter is in next chapter.


measures. As mentioned in the last section, the takeover market often sparks bitter battles for the control of a target company between the bidder, the target board, and the target shareholders. One of the contentious regulation matters is whether to empower the target board with sufficient discretion to fend off an unsolicited offer. Such discretion might deter undervalued offers to protect the interests of the target shareholders. But it might also cause the abuse of the target board to preserve their incumbent managing position from a successful hostile offer that would benefit the target shareholders.51

In China, a non-frustration rule has been endorsed as one of the basic principles from the inception of the regulatory regime.52 Accordingly, the board of a target company is only permitted to adopt defensive mechanisms with the shareholders’ approval; or to continue to carry on activities in the ordinary course of its business.53 The Chinese non-frustration rule appears to be similar to the principle of “board neutrality” in the UK.

As provided under the UK Takeover Code, the target shareholders enjoy the primary power in taking defensive measures. Without shareholder approval, the target board is prevented from taking defensive measures during the course of an offer, or even before the date of the offer.54 Nevertheless, the Chinese takeover law has not provided supplementary rules and enforcement mechanisms as proscribed under the Rule 21 in the UK Takeover Code. As a consequence, a target board in China de facto enjoys a wide discretion in practice similar to the target board in the US in adopting a wide range of defensive measures.55

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53 Article 33, The Administrative Measures for the Takeover of Listed Companies.
54 The principle of “board neutrality” is provided under the General Principle 3 and further elaborated under the Rule 21, Restrictions on Frustrating Action within the UK Takeover Code.
1.2.3 How to Explain the Regulatory Heterogeneity?

What could explain the existence of distinct regulatory regimes regarding takeovers across various jurisdictions? Should these distinctions be expected to persist or to disappear under the continuing technology development, economic progress, and global competition? To answer these questions, this thesis will apply the path dependence theory as the theoretical research framework. The basic idea of path dependence theory is that early developments may have profound and disproportionate effects on the path of subsequent development. As suggested by Margaret Levi, path dependency means:

> “That once a country or region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice. Perhaps the better metaphor is a tree, rather than a path. From the same trunk, there are many different branches and smaller branches. Although it is possible to turn around or to clamber from one to the other — and essential if the chosen branch dies — the branch on which a climber begins is the one she tends to follow.”

The path dependency theoretical framework postulates with three main defining premises: the existence of multi-Equilibria; the sensitive dependence on initial conditions and the self-reinforcing effects. Consequently, this research on Chinese takeover regime and its shaping forces is set to test a primary hypothesis with accompanying three sub-hypotheses as follows:

### Table 1.1, Hypotheses

<table>
<thead>
<tr>
<th>The hypothesis</th>
<th>Primary hypothesis</th>
<th>There is a strong path dependency for the China’s regulatory regime governing its takeover market.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub-hypothesis I</td>
<td>The shape of China’s regulatory regime exhibits sensitive dependence on its initial conditions, i.e., the origins of the current Chinese general...</td>
<td></td>
</tr>
</tbody>
</table>

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legal system and corporate regulations.

**Sub-hypothesis II**

The shape of China’s regulatory regime has been subjected to lock-in effects due to its unique political economy constraints, e.g., the Party-State polity, the roles of government not only as the market regulator but also a significant market player.

**Sub-hypothesis III**

The featuring pattern of the takeover regulatory regime in China will persist due to the path dependency phenomenon, hence regulatory heterogeneity will remain across the world.

Both the theoretical framework and research hypotheses are set to address the following research questions:

**Table 1.2, Research Questions**

<table>
<thead>
<tr>
<th>Positive research questions</th>
<th>What are the current main regulatory patterns across the world in regulating the takeover market?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>What are the characteristics of Chinese takeover regulatory regime?</td>
</tr>
<tr>
<td>Inferential research questions</td>
<td>What forces have shaped China’s takeover regulatory regime?</td>
</tr>
<tr>
<td></td>
<td>Whether divergence or convergence would take place in the field of comparative takeover regulations?</td>
</tr>
</tbody>
</table>

**1.3 Research Contributions**

Studies conducted to explain the diversity in takeover regulations have mostly focused on the advanced markets; literature on emerging markets is relatively rare.58

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For studies on emerging market, see, for example, Bliss Burdett Pak, ‘National Markets and New Defenses: The Case for an East Asian Opt-In Takeover Law’ (2007) 20 Columbia Journal of Asian Law 385;
But the regulatory regimes in emerging markets deserve attention. Statistical evidence has shown that the number of takeover activities, although the total amount is still relatively low compared to that of the advanced markets, has grown enormously in recent years in emerging markets, especially those of the BRICS countries.\textsuperscript{59}

This thesis takes China, one of the most significant emerging markets, as a sample study to explore the status quo of the regulatory regime and the path leading to its current regulatory equilibrium. The institution of publicly listing companies and the market for corporate control is relatively new in China. Nevertheless, one can observe a dramatic growth in the last decade. (Graph 1.1)

Graph 1.1 M&A Market in China

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Another article touches the takeover regulations on emerging markets, although it is extrapolated from the analysis of developed economies. See further in Armour, Jacobs and Milhaupt, ‘The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework’ (2011) 52 The Harvard International Law Journal 219

A case study on Chinese takeover law provides scholarship an opportunity to examine the evolution of the market and its regulatory system in real time and over much short time periods. It has been well documented that the research on advanced jurisdictions will facilitate the understanding of emerging markets. By extrapolating from a path dependency study on Chinese takeover law, we can test the theory applied to interpret the legal development within advanced jurisdictions, and provide a fresh sample, maybe unique, for the new research on legal developments.

The author also expects, through this empirical study, that more discussion on the emerging markets would be brought to the table. These discussions will be illuminating to scholars, practitioners, and policy makers to better understand the reform pathway of the interlinking worldwide regulatory regimes; and to identify or nourish shaping forces for more optimal legal development in the future.

1.4 Research Methodologies

A research methodology shows how the analysis of research questions is articulated. This thesis applies a set of research methodologies as follows:

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60 See, for example, ibid
1.4.1 Case study strategy

Case study differs from other research methods because the attention is focused on the individual case and not the general. By focusing on the individual case, it is hoped to provide a detailed examination of the intricate network of factors and their interaction with particular events, which work together to determine the nature of the phenomenon being studied.61

For the purpose of this thesis, the author will explore a cluster of leading cases where fierce takeover battles were fought. In these cases, a myriad of anti-takeover tactics, varying from cross shareholding, golden parachute, change of control clauses, staggered board, anti-trust revision, white knight, crown jewel sale, etc were introduced to prevent or defend a company from an unsolicited takeover bid.62

These battles have brought about discussions and reflections on the adequacy of applicable regulatory regimes. Some of them have set standards binding on subsequent cases;63 others have triggered amendments to the existing regulatory regime.64

Take the *Unocal v. Mesa Petroleum* for a brief example.65 The *Unocal* case has been considered as one of the most important US corporate law cases of the past half century, with far-reaching “doctrinal and economic consequences”.66 It established a template for judicial review of target board defensive tactics in the face of a hostile acquisition bid; signaled judicial approval of disparate treatment of shareholders that paved the way for a revolutionary defensive tactic, the “poison pill,” that reshaped

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62 Detailed discussion of these cases is followed in the next Chapter on the features of takeover regulations in China.
63 For instance, the US *Unocal Corp. v. Mesa Petroleum Co.* in 1985 has set up the Unocal standard as to determine the power boundary of target boards when the boards are initiating defensive measures. Paul L. Regan, “What's left of Unocal?” (2001) 26 Delaware Journal of Corporate Law 947 Further discussions are in following chapters.
64 For instance, the takeover of the UK based Cadbury by the US based Kraft in 2010 prompted a revamp of the UK takeover rules. Blanaid Clarke, “Directors' Duties in a Changing World: Lessons from the Cadbury Plc. Takeover” (2010) 7 European Company Law 204 Further discussions are in following chapters.
65 Further discussion in chapter 2
takeover strategy; and added impetus to the creation of the “junk bond” market that opened up the takeover market to a new group of takeover entrepreneurs.\textsuperscript{67}

For another example, the first hostile takeover case in China occurs in 1993 between Yanzhong Plc. as a target, and Bao’an Plc. as a bidder.\textsuperscript{68} This case is vital not only because it lifts the curtain of the market for the corporate control, hence a new epoch in the history of the Chinese securities market; but also it imposes the first regulatory challenge on the competency of the newly established regulatory institution, the CSRC; and the adequacy of the newly released \textit{Interim Provisions on the Management of the Issuing and Trading of Stocks}.\textsuperscript{69}

\subsection*{1.4.2 Comparative law strategy}

The studies of path dependency and the approach of comparative law fit together well, because comparative law methodology provides “natural experiments of variant evolutionary paths”.\textsuperscript{70} The comparison of laws, at least in their geographical diversity, is as old as the science of law itself.\textsuperscript{71} Comparative law could be considered as an academic discipline for the study of separate legal systems.\textsuperscript{72} It could also be considered as a main research method.\textsuperscript{73} As Schlesinger suggests:\textsuperscript{74}

\begin{quote}
Comparative Law is ... a method, a way of looking at legal problems. Strictly speaking, the term Comparative Law is a misnomer. It would be more logical to speak of the Comparative Method... The German term rechtsvergleichung,
\end{quote}

\begin{itemize}
\item 67 Ibid
\item 68 For the purpose of defense, the Yanzhong, apart from referring to public propaganda, white knights, self-tender, etc., took the litigation as a defensive measure, i.e., suing the Bao’an for breach of the information disclosure requirement and the notification obligation which was triggered when the Bao’an reached the threshold of acquiring 5\% of the outstanding shares. This battle, however, ended up with the intervention by the watchdog of the Chinese securities market, i.e., the China Securities Regulatory Commission (CSRC), instead of with a judicial decision by the court. The newly established administrative regulator penalized the Bao’an with a fine of one million Renminbi for the breach of relevant mandatory rules; although it ratified the corporate control of Yanzhong by Bao’an, for which the latter held 18.71\% of the former’s outstanding stock. Meanwhile all the existing directors of Yanzhong were retained, apart from one representative for Bao’an who was elected onto the board of Yanzhong as the vice chairperson.
\item 69 The \textit{Interim Provisions on the Management of the Issuing and Trading of Stocks} was published by the State Council in 1993. Although remaining effective, many of the rules of the Interim Provisions have been amended or replaced by other later promulgated laws. More details are discussed in Chapter 3.
\item 71 René David and John E. C. Brierly, \textit{Major Legal Systems in the World Today} (Legal Classics Library 2000) Page 1
\item 72 See, for example, Konrad Zweigert, Hein Kotz and Tony Weir, \textit{An Introduction to Comparative Law} (Clarendon Press 1998)
\item 73 See, for example, Mathias Siems, \textit{Comparative Law} (Cambridge University Press 2014)
\item 74 Ugo Mattei and others, \textit{Schlesinger's Comparative Law: Cases, Text, Materials} (Foundation Press 2009) Page 1
\end{itemize}
and to a lesser degree the French droit comparé (law compared), are more accurate in that they emphasize the nature of the subject as a process or method.

For the purpose of this thesis to examine the features of Chinese takeover regime and its underling shaping forces, the author chooses the UK and the US as comparative reference points. This is not only because the UK and the US represent two of the most developed markets for corporate control. It is also motivated by the fact that these two jurisdictions have been exerting a very significant influence on the development of takeover regimes in other jurisdictions, including China.75 A comparative study on Chinese regulatory pattern referring to the UK and the US, will not only discover and explain the similarities and differences of the regulatory patterns within these jurisdictions, but also evaluate the influence and the reception of law from one jurisdiction to another.

The author will endeavour a two-dimension comparative law research method as proposed by Zweigert and Kötz. The first dimension is the so-called Macro-comparison, which compares the spirit and style of different legal systems, the methods of thought and procedures they use and the contextual social, cultural, and political economic background.76 The second dimension is the so-called Micro-comparison, which compares the specific legal institutions and rules utilized to solve actual problems or particular conflicts of interests.77

In the aspect of the Macro-comparison, the author will endeavour to analyse the different legal systems, economic and political backgrounds between China, the UK and the US. It will be documented that it is the combination of the historical legal influences, the socialist market economy and the centralized political system that makes the takeover legal regime in China distinct from the regimes in the UK and the US.78

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75 Many other jurisdictions have been influenced by these two models, for example, many European countries such as Ireland, France, Italy, and etc., by the UK; while Netherland by the US. Magnuson, ‘Takeover Regulation in the United States and Europe: An Institutional Approach’ (2009) 21 Pace International Law Review 205 Their influences on Chinese law will be discussed in following chapters, especially Chapter III.
77 Ibid Page 5
78 More detailed discussion is provided in the following chapter 2&3. See generally Chao Xi, ‘In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China’ (2006) 22 Connecticut Journal of International Law 1 Guanghua Yu, Comparative Corporate Governance in China: Political Economy and Legal Infrastructure (Routledge 2007)
In the aspect of the Micro-comparison, both the substantive rules and regulatory institutions vary from one jurisdiction to another. China has ostensibly adopted a set of substantive rules rather similar to those in the UK, such as the mandatory bid rule,\(^{79}\) and the neutrality of the target board as a principle during a hostile takeover.\(^{80}\) Meanwhile, Chinese regulatory institutions feature with a government agency exercising its control-based regulatory approach. This is different from the Panel based system in the UK and the judicial branch dominated institutional structure in the US.\(^{81}\)

### 1.4.3 Deductive research strategy

Deductive research is usually reserved for theory-driven research as opposed to research that seeks to derive theories from empirical evidence. This term, sometimes labeled as a “hypothetico-deductive” method\(^{82}\), begins with clear assumptions in order to understand a particular problem or to find answers to the problem. The acceptability or the false nature of the assumptions is tested by checking whether their logical consequences are consistent with the available empirical evidence or not.\(^{83}\)

For the purpose of this thesis, the author applies the theory of path dependence and places it towards the beginning of the research plan. Based on previous discussions and debates on path dependency within scholarship from economics, politics, biology, and legal studies, the author extracts three defining features for a comprehensive framework of the path dependent theory. These features, could be summarized as: the existence of multi-Equilibria; the sensitive dependence on initial conditions and the self-reinforcing effects.

The theory with these features will be the organizing model to respond to the previously proposed positive and inferential research questions; and to test the primary and affiliates hypotheses. The examination of Chinese takeover law and its

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81 More detailed discussion is provided in the following chapters.
83 Jonathan Grix, Demystifying Postgraduate Research: From MA to PhD (University of Birmingham Press 2001) Page 133
evolution will provide the empirical evidence to test the acceptability or the false nature of this comprehensive framework.

1.4.4 Document analysis strategy

Document analysis is a systematic procedure for reviewing or evaluating documents, which present a set of information pertaining to a topic, structured for human comprehension, represented by a variety of symbols, stored and handled as a unit.\(^84\) Documents used for systematic evaluation may take a variety of forms, such as: the wordings of laws, the minutes of proceedings, reports, letters, press articles, books, organization charts and etc.\(^85\)

The author, for the study of takeover regulations, will distinguish primary source documents from secondary source documents. The primary sources are those authoritative records of law made by law-making bodies.\(^86\) In the case of the Chinese takeover regulatory regime, for example, the primary source documents include: (i) statutes, e.g., *Company Act, Securities Act*, which were promulgated by the legislatures; (ii) administrative regulations, e.g. *Interim Provisions on the Management of the Issuing and Trading of Stocks* published by the State Council, *Administrative Regulations on the Takeover of Listed Companies* by the China Securities Regulatory Commission (CSRC); (iii) decisions referring to particular cases made by courts or the administrative regulatory authority. The secondary sources, mainly commentaries involving generalization, analysis, interpretation, or evaluation of the primary sources, are those documents that refer or relate to the primary sources.\(^87\)

Moreover, the author will apply a sophisticated form of document analysis, namely discourse analysis. This technique, borrowed from linguistics, studies the shifts and


\(^{85}\) Since these documents have their origin in everyday contexts and there is no contact between the researcher and the production of the investigation material, document analysis is a non-reactive method. Blackwell Reference Online, Document Analysis, http://www.blackwellreference.com/subscriber/uid=1240/tocnode?id=g9781405131995_chunk_g97814051319959_sss62-1.

\(^{86}\) Robert Watt, *Concise Legal Research* (Federation Press 2004) Page 1

\(^{87}\) Ibid Page 2
turns in the particular usage of language over time. The author will apply this approach to analyze the critical terms used in particular with respect to the primary source documents. For example, the author will examine the frequency of phrases such as “Party Leadership”, in various official documents appearing in different time periods in China. A conclusion will be reached that the control of the ruling party in China’s Party-State governance structure has only entrenched within the recent period, which affects the powers and rights structure between the directors and shareholders Chinese companies.

1.5 Chapter Outline

In addition to this introductory chapter, the thesis is composed of three Parts and a final Concluding Chapter. Each Part is further divided into two chapters. The thesis, as a whole, consists of eight chapters. The following section presents the outline.

Part I: Multiple Regulatory Equilibria for Takeover Markets

The discussion of the path dependency phenomenon is based on the existence of multiple equilibria. The task of examining the dependent path that has led to the current regulatory equilibrium will start with a survey of the unique features of the existing regulatory regimes governing the takeover market in China. This survey will be conducted along with a comparative review of the two main regulatory patterns as represented by the UK and the US respectively.

A pattern of a regulatory regime is defined from three aspects: the regulation framework, by which the structure of regulatory institutions and content of substantive rules are provided; the regulatory institution, on which the regulatory powers are shed; the substantive rules, with which the involved parties should comply.

For the first aspect, China has established a set of regulation framework within which the dominant is a patchwork of administrative departmental rules issued by departments with the State Council, especially the CSRC. This contrasts with the

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89 More detailed discussion can be found in the chapter 7.
traditional dominance of the private Takeover Code in the UK,\textsuperscript{90} and a combination of statutes and case law in the US.\textsuperscript{91}

For the second aspect, compared to the prominent roles played by, for example, the Takeover Panel in the UK and Courts of Delaware in the US, a ministry-level administrative institution, i.e., the CSRC, has been predominant in the regulation of the takeover market. The roles of the CSRC include both providing and enforcing takeover rules.

For the third aspect, substantive rules such as the principle of “board neutrality” have been adopted as one of the basic takeover rules in China. Accordingly, the board of a target company is only permitted to adopt defensive mechanisms with the shareholders’ approval; or to continue to carry on activities in the ordinary course of its business. The Chinese non-frustration rule appears to be similar to the principle of “board neutrality” in the UK. But a target board in China \textit{de facto} enjoys a wide discretion in practice similar to the target board in the US in adopting a wide range of defensive measures.\textsuperscript{92}

The Part I is divided into two chapter to investigate the state of art of the regulatory heterogeneity of takeover markets. Chapter 2 focuses on the UK and the US; Chapter 3 focuses on China. This comparative examination serves to impart a positive message: the existence of a multiplicity of “locally stable equilibria”\textsuperscript{93} of takeover regulatory regimes across jurisdictions. The analysis provides a contextual background to the quest of identifying the manifold selection mechanisms, which, “in the conceptualization of path dependence as a branching process corresponds to looking for critical bifurcations in the sequence of development.”\textsuperscript{94}

\textsuperscript{90} The City Code has a statutory status upon the implementation the EU Takeover Directive 2004. Nevertheless, its feature as a self-regulation system has not been altered. See further discussion under the following Chapter II.


\textsuperscript{92} A full list of legitimately available defensive mechanisms, both anticipatory defensive measures and responsive defensive measures, will be identified after clarifying the current rules. See further under Chapter 3

\textsuperscript{93} David, ‘Path Dependence: A Foundational Concept for Historical Social Science’ (2007) 1 Cliometrica 91

\textsuperscript{94} Ibid
Part II: Understanding the Regulatory Heterogeneity from the Path Dependency on Original Conditions

This part examines the second defining pillar of the path dependence theory and its explanatory power regarding China’s takeover regime. The path dependence literature has presented scholarship with a nonlinear dynamic model, also known as the chaos model, a key finding of which is that a path dependency phenomenon tends to manifest itself through the sensitive dependence on initial conditions. Therefore, the second feature for path dependence could be defined as a seemingly inconsequential lead for technologies, institutions, or systems. The inconsequential lead may have important and irreversible influences on the ultimate development of technologies, institutions, or systems.

Thus, a regulatory regime existing today is conditioned on its past trajectory. This method of interpretation corresponds very closely to the legal origins theory advocated by the law and finance scholarship, which suggests that the historical origin of a country’s legal system is statistically and economically significant for the current regulatory institutions and substantive rules, and, with a broad range, the general economic outcomes.

Having interpreted legal origins as highly persistent systems of social control of economic life, law and finance scholars trace the different regulatory styles of common and civil law to distinct ideologies about law and its function that England and France perceived centuries ago. It argues that those early perceptions have been imprinted not only into human capital and beliefs of its participants, but also in the organization of the legal system, even the substantial legal rules found today.

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95 Jack A. Goldstone, ‘Initial Conditions, General Laws, Path Dependence, and Explanation in Historical Sociology’ 104 American Journal of Sociology 829
97 See further discussion on legal origins theory in Part II. See generally Simon Deakin and Katharina Pistor (eds), *Legal Origin Theory* (Edward Elgar Publisher 2012) This edited book compiles key contributions to the law and finance scholarship. It highlights both the major contributions to and the inherent limits of the legal origin literature.
Moreover, when the common law or the civil law was transplanted into another part of the world through either colonization or modernization, the initial perceptions were transplanted as well. As a consequence, the fundamental strategies and assumptions of either legal system have survived and continued to exert substantial influence on the regulatory patterns and economic outcomes, despite local adoption.  

This view is not without criticism. The author argues that for a hybrid jurisdiction like China, the critical challenge is to keep track of its legal development, and to identify the dominant legal origins for the particular legal sector observed. A conclusion would be reached that the main presumption of legal origins theory, which is based on the classification of legal systems into different legal families, is neither consistent with the evolution of the Chinese legal system; nor analytically useful for a better understanding of the Chinese current regulatory pattern in hostile takeover matters.

Nevertheless, certain elements of the legal and finance literature are of utility regarding the research purpose of this thesis. Essentially, the legal origins hypothesis claims that the crystallization of a particular legal infrastructure or order, which in the case of most countries occurred at some point in the 19th century or at the latest in the early 20th century, is still influencing the regulatory style to this day. As will be further explored in following chapters, the reform agenda initiated by the Late Qing Government at the late 19th century and early 20th century has laid down a basic civil law system, which, along with the traditional law and the Marxism, influences the following legal evolution in China. As a consequence, the administrative branch has enjoyed the unapportionable power in the hostile takeover regulations; whilst the judicial branch has retreated from the intervention into the takeover regulations.

101 See generally: Deakin and Pistor (eds), Legal Origin Theory (Edward Elgar Publisher 2012) Further discussion in Part II
Part III: Understanding the Regulatory Heterogeneity from the Self-Reinforcing Path Dependency

This part examines the third defining pillar of the path dependence theory and its explanatory power regarding regulatory heterogeneity of takeover regulation. This third pillar, namely the self-reinforcing path dependency, suggests that, depending on the initial conditions, regulatory activities may be subject to increasing returns while the comparative costs of exploring alternatives steadily rises hence the dynamic system is locked into a chosen path. Analysis of this self-reinforcing mechanism, together with the analysis of initial conditions undertaken in the Part II, contributes to understanding why China’s regulatory pattern has evolved in a particular way, and sheds light on what direction this pattern is likely to take in the future.

To achieve this purpose, this part incorporates the political economy literature to enrich the self-reinforcing path dependency discussion on the shape of takeover regulatory regimes.\textsuperscript{104} The political economy literature argues that the evolution of legal systems tends to be endogenous to the processes of economic and political development; hence much of what happens and who benefits under the given legal system is driven by its political economy constraints.\textsuperscript{105}

The analysis is to test one of the hypotheses as proposed in chapter 1, namely, the takeover regime has demonstrated lock-in effects due to the self-reinforcing path dependence phenomenon caused by the embedded political economy context. The evolution of legal systems is endogenous to the processes of economic and political development. A path dependency on political economy constraints thus accounts for the differences of takeover law and practice models among examined jurisdictions, i.e., the UK, the US and China.

The self-reinforcing path dependency from political economy perspectives looks at how policy makers embedded within both macro and micro political economy constraints to create regulatory outcomes. While the UK takeover regulation is

\textsuperscript{104} See further detailed discussion on Chapter 6.

constrained by its featuring City – State political economy ecology; the US takeover regulation is constrained by its Federal – State system.

In contrast, a Party-State is the most important factor within China’s political economy ecology. The Party, i.e., China’s Communist Party or CCP, as Chairman Mao proclaimed, is “the leader of all” in China. It has a ubiquitous institutional presence in the governmental structure of the China’s polity. The Party has a self-serving political economy objective to maintain itself as the monopolistic control of the State and the society. The objective determines the general policy orientation toward the reform of State-owned enterprises and the development of the securities market, which constitutes the backdrop of takeover market and regulations.

**Conclusion**

The aim of this thesis is to test if there is a significant path dependence phenomenon in the shape of the takeover regimes in China, the UK and the US. It investigates why the legal regime in each country has presented itself with unique features and how can the diversity be attributed to the path dependence phenomenon: the persistent influence of initial conditions and the self-reinforcing mechanism.

The explanatory power of the path dependent theory could be enhanced when it is enriched with two main streams of law and development literature: law and finance on one the hand, political economy on the other hand. The interplay of the legal origins and the political economy has contributed to the establishment of a regulatory pattern with Chinese characteristics, which differentiate itself from either the UK pattern or the US pattern. This theoretical approach expatiated in this thesis should increase the applicability of path dependence as an explanatory concept and lay the ground for the law and development analysis in more depth in the future.

This analysis also concludes that the diversity of corporate governance systems across jurisdictions will persist, hence the “End of the History for Corporate Law” era will not come true very soon. The State controlled economy in China will continue along with the non-liberal political and legal system, hence Fukuyama’s “End of History” idea would not be as sound as it appeared in 1989.
Part I:
Multiple Regulatory Equilibria for Takeover Markets

As discussed in Chapter 1, the existence of multiple Equilibria is a precondition for discussion of the path dependency phenomenon. Therefore, the core theme of this Part is to examine the current regulatory equilibrium of China’s takeover regime, preceded by a comparative review of the two-main takeover regulatory patterns, represented by the UK regime and the US regime.

Examination of China’s takeover regime, with reference to the UK and US regimes for comparative context, will serve to address two research questions: (i) what are the current main patterns of regulation across the world in relation to takeover markets? and (ii) what are the characteristics of China’s current legal regime with respect to its takeover market? The answers to these two questions impart a positive message: the existence of a multiplicity of locally stable equilibria regarding patterns of regulation of takeover markets across jurisdictions.

The contribution of this Part is to provide a contextual background to the quest as undertaken in the subsequent two Parts to identify the selection mechanisms, which, in the conceptualization of path dependency on legal origins and political economy influences, shape the hostile takeover regulatory pattern in China. The subsequent sections firstly examine the two main regulatory patterns represented by the UK and the US respectively, followed by defining the features of the existing regulation framework, regulatory instantiations and substantive rules regarding takeovers in China.
Chapter 2: Diverse Takeover Regulatory Patterns in the UK and the US

Introduction

This Chapter is to compare the features of regulatory patterns in the UK and the US in relation to the takeover regulations. As discussed in Chapter 1, a pattern of a regulatory regime is defined by its three components, namely: *the regulation framework*, by which the structure of regulatory institutions and content of substantive rules are provided; *the regulatory institution*, on which the regulatory powers are shed; *the substantive rules*, with which the participating players of the takeover market should comply.

A regulation framework, comprised of statutes, judicial decisions, administrative rules, or self-regulatory arrangements, may present itself as a specific rule-based regulation; a general standard-based regulation, or a combination of both. The enforcement of a regulation framework, here the regulatory powers pertaining to takeovers, may be conferred on a regulatory institution specifically designated for the takeover market. Such regulatory powers may also fall within the scope of a regulatory institution over the general financial market regulator, or the court as the general adjudicator.

The contents of substantive rules also vary across jurisdictions. The examples are those rules governing matters such as the distribution between management and shareholders of the decision power in relation to the initiation of defensive measures against unsolicited offers or the availability of the mandatory bid rule to protect minority shareholders.

106 See further in the Section 1.2.2, Chapter 1
107 Definitions of both the specific rule based regulations and the general standard based regulation are discussed under the *infra* Section 2.1.
109 In brief, the Mandatory Bid Rule (MBR) mandates that a shareholder who has acquired certain percentage of shares to make an general offer for the remaining shares at a fair price. The Mandatory Bid Rule is considered to be capable of providing a great degree of equal treatment amongst all target shareholders, since the control premium is shared amongst all shareholders. However, the Rule is often criticised for preventing value increasing transactions. See also Edmund-Philipp Schuster, ‘The Mandatory Bid Rule: Efficient, After All?’ 76 The Modern
The purposes of this comparative analysis of takeover regulatory patterns in the UK and the US are two-fold. Firstly, the contrasting features between these two jurisdictions endorse the existence of multiple Equilibria in relation to the takeover regulatory patterns. As discussed in the first Chapter, the discussion on the path dependence dynamic is pre-conditioned on the very existence of multiple Equilibria. Secondly, the analysis of these two regulatory patterns provides an analytical framework for the comparative examination of the Chinese regulatory pattern, which will be the focus of Chapter 3.

2.1 Diverse Takeover Regulation Frameworks: Specific Rule-based Regulation vs General Standard-based Regulation

There is an absence of a clear and fixed definition for the terms “Rule” and “Standard” in the scholarly literature. In principle, when governing certain legal aspects, a specific rule “prescribes specific behaviors” for the regulatory objects while a general standard “leaves the precise determination of compliance” to adjudicators (e.g., judges, juries, or administrators).

“Rules” and “Standards” can be understood as two endpoints of a regulation spectrum. (Figure 2.1) The regulation spectrum spans from the Rules-based Regulations, through the Grey Area, to the Standards-based Regulations. The Rules-based Regulations include Pure Rules applied consistently and persistently, and rules applied with exceptions and qualifications. Standards-based Regulations include Pure Standards specifying no triggering legal facts, and Standards relying on established judicial precedents. The Grey Area is where “Rules” and “Standards” are interchangeable, where it is difficult to classify one regulation as a rule or a standard.

Figure 2.1, Regulation Spectrum

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The following sections will discuss, the UK takeover regulation framework features a specific rule-based regulation, where an exhaustive Takeover Code prescribes the structure of regulatory institutions and content of substantive rules. In contrast, the US Takeover regulation lacks a unified comprehensive framework. Instead, it features a dual level regulation framework. On the one hand, the federal and state legislatures provide limited rules governing information disclosure and procedural requirements; on the other hand, the state courts apply the fiduciary duties to develop a series of standards to regulate substantive matters such as the decision power regarding the anti-takeover measures.

2.1.1 The Specific Rule-based Regulation Framework in the UK

In the UK, it is predominantly the Takeover Code, also called the City Code on Takeovers and Mergers (The Code), which has set rules to comprehensively regulate takeover markets. Legislation like the UK Companies Act 2006, and regulations made pertaining to these statutes, perform supplementary roles. This section will examine briefly the history of the Takeover Code, then focus on the jurisdiction and content of the Takeover Code. Relevant provisions under the UK Companies Act 2006 will be also studied during this analyzing process.

2.1.1.1 Brief History of the Takeover Code

The development of the Takeover Code can be traced back to the 1960s. At that time, underutilization of assets and mismanagement in the burgeoning takeover market rendered many British firms “ripe targets”. But unfair practices, especially various
defensive measures adopted by target boards, fuelled mounting concerns about the interests of shareholders.118 Due to the time-consuming nature and uncertain results of the litigation process, investors were not satisfied with litigation as a remedial approach to the unfair practices in the takeover market.119

To instil fair practice in the takeover market, the Bank of England in 1959 set up a City Working Party, formed of representatives from institutional investment entities, merchants and commercial banks, and major organisations in the City.120 The City Working Party introduced the Notes on Amalgamation of British Businesses (The Notes) in the same year. The Notes, failed to serve their purpose, to adequately protect shareholders for the reason of lacking mechanisms for adjudication and enforcement.121

The Bank of England in 1967 convened a drafting committee composed of the main city institutions to formulate a comprehensive code based on the Notes. That code was published and entered into effect in 1968 as the City Code on Takeovers and Mergers (The Takeover Code). Shortly thereafter, a Takeover Panel 122 composed of representatives from the aforementioned institutions was established to supervise the administration of the Takeover Code and to issue authoritative interpretations on its application to specific cases.123

Since its adoption, the Takeover Code, as interpreted and implemented by the Takeover Panel, has functioned as a voluntary code of conduct to regulate the conduct of market players.124 This self-regulatory approach has been considered fundamental to the UK takeover regulation, given the historic philosophy of self-regulatory capital markets in the UK.125

120 ‘They were: the London Stock Exchange, the Issuing House Committee, the Accepting Houses Committee, the Association of Investment Trusts, The Committee of London Clearing Bankers and The British Insurance Association.
122 A discussion on the structure and functions of the Takeover Panel is the theme of the infra Section 2.2.1
124 The administration of the Code by the Takeover Panel is examined in the infra Section 2.2.1
The Takeover Code as a voluntary code of conduct has been ostensibly changed as a consequence of the EU Takeover Directive (2004/25/EC) (The Takeover Directive) and its transposition in the UK by means of Part 28 of the Companies Act 2006.\textsuperscript{126} The rules set out in the Takeover Code have now been formally granted a statutory basis and have to comply with the relevant requirements of the Takeover Directive. Nevertheless, “the company law may be helpful but does not impinge on the autonomy of the Code.”\textsuperscript{127} In theory, the implementation of the Takeover Directive has changed the UK regulation framework of takeovers from self-regulation to statutory regulation. In practice, however, the regulation framework and its enforcement remains a non-governmental approach. The Takeover Directive did not require many significant changes to the provisions of the Takeover Code.\textsuperscript{128} As pointed out by the Takeover Panel: “[w]hile…the status of the Code will be different under the new statutory regime, there will be little material substantive change…to the Rules of the Code.”\textsuperscript{129} Essentially, the Takeover Code should continue to be viewed as a self-regulatory instrument.\textsuperscript{130} The following section examines the jurisdiction and contents of the Takeover Code.

### 2.1.1.2 Regulatory Scope of the Takeover Code

Broadly speaking, the Takeover Code applies to offers for companies and \textit{Societas Europaea} that have their registered offices in the UK, the Channel Islands or the Isle of Man if: (i) any of their equity securities are admitted to trading on a regulated market in the UK or any stock exchange in the Channel Islands or the Isle of Man; or (ii) they are considered by the Panel to have their place of central management and control in the UK, the Channel Islands or the Isle of Man.\textsuperscript{131} The Takeover Code may

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\textsuperscript{126} The transposition of the Takeover Directive will be examined in \textit{infra} Section 2.2.1.1


\textsuperscript{128} The reason for this is that, as a historical matter, the contents of that Directive were modelled almost entirely on the provisions of the City Code. These are precisely the provisions that the Panel, which remains representative of financial institutions, would have been least likely to alter. Johnston, ‘Takeover Regulation: Historical and Theoretical Perspectives on the City Code’ (2007) 66 The Cambridge Law Journal 422; Mukwiri, ‘The Myth of Tactical Litigation in UK Takeovers’ (2008) 8 Journal of Corporate Law Studies 373


\textsuperscript{130} Johnston, ‘Takeover Regulation: Historical and Theoretical Perspectives on the City Code’ (2007) 66 The Cambridge Law Journal 422

\textsuperscript{131} Section A, \textit{Introduction}, The Takeover Code
The Takeover Code also applies to UK and other European Economic Area (EEA) registered and traded companies under shared jurisdiction arrangements in the EEA. As with regulated transactions, the Takeover Code is concerned with both takeover bids and merger transactions, including statutory merger or scheme of arrangement, of the aforementioned companies. The Takeover Code is also concerned with regulating other transactions that have as their objective or potential effect, directly or indirectly, obtaining or consolidating control of relevant companies, as well as partial offers to shareholders for securities in the relevant companies. Furthermore, the Takeover Code applies to unitisation proposals, which are in competition with another transaction to which the Code applies.

2.1.1.3 Regulatory Approach of the Takeover Code

The Takeover Code purports to implement appropriate business standards, deliver fairness to shareholders and assure an orderly framework for takeovers. To achieve this underlying purpose, the Takeover Code has developed a regulatory approach combing both principles and rules to govern the process pertaining to takeover transactions.

The current Takeover Code is based upon a total number of six General Principles, which are the same as the general principles prescribed under the Article 3 of the Takeover Directive. (For the content of the six principles, see Appendix 2.1)

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132 The circumstances include:
1) any of their securities have been admitted to the Official List at any time during the 10 years prior to the relevant date; or
2) dealings and/or prices at which persons were willing to deal in any of their securities have been published on a regular basis for a continuous period of at least six months in the 10 years prior to the relevant date, whether via a newspaper, electronic price quotation system or otherwise; or
3) any of their securities have been subject to a marketing arrangement as described in section 693(3)(b) of the Act at any time during the 10 years prior to the relevant date; or
4) they were required to file a prospectus for the issue of securities with the registrar of companies or any other relevant authority in the United Kingdom, the Channel Islands or the Isle of Man or to have a prospectus approved by the UKLA at any time during the 10 years prior to the relevant date.

133 See further under the Section A, Introduction, ibid

134 These transactions include offers by a parent company for shares in its subsidiary, dual holding company transactions, new share issues, share capital reorganisations and offers to minority shareholders. Section A, Introduction, ibid

135 See further under the Section A, Introduction, ibid


138 Before the transposition of the Takeover Directive, the Takeover Code included a number of ten General Principles.
Expressed in broad general terms, these Principles are essentially the statements of standards of commercial behaviour. The Takeover Code does not define the precise extent of, or the limitations on, their application. The Principles are “applied in accordance with their spirit in order to achieve their underlying purpose.”\textsuperscript{139}

In addition to the General Principles, the Code contains a series of thirty-eight specific rules that fall into two categories: expansions of the General Principles and provisions governing specific aspects of takeover procedure. Although most of them are expressed in less general terms than the General Principles, these rules are not framed in technical language and, like the General Principles, are to be interpreted to achieve their underlying purpose. Therefore, when these rules are applied to takeover transactions, “their spirit must be observed as well as their letter.”\textsuperscript{140}

2.1.2 The Combination of Specific Rule-based and General Standard-based Regulation Framework in the US

Due to the dual regime of federal and State laws, takeover regulations in the US operate within a dual framework instead of the unified specific regulation framework as the UK Takeover Code represents.\textsuperscript{141} Takeovers in the US are regulated at both the federal and state levels, albeit each level has its own focus.

On one hand, the Federal Congress and the SEC provide the federal-level regulations, such as the Williams Act 1968 and its implementing rules, to regulate takeover transactions, especially those involving the tender offer procedure and the information disclosure issues. On the other hand, anti-takeover statutes and judicial decisions at

\textsuperscript{139} Section A, Introduction, The Takeover Code
\textsuperscript{140} Section A, Introduction, ibid
\textsuperscript{141} For better understanding the “dualism” in the American legal system, the following should be pointed out: the American legal system is based around a system of federalism, which refers to shared powers among the states and federal governments. The federal government is a government of limited powers, which are prescribed in the US Constitution. The states retain all powers, which are not expressly left exclusively to the federal government in the US Constitution. Federal law almost always pre-empts state law. Consequently, if there is both a federal and a state statute on the same topic, the federal statute will pre-empt the state statute to the extent that the two are inconsistent. It is also possible, when Congress and state legislatures enact laws governing the same conduct - like rules governing takeovers - that these laws coexist and a defendant is subject to both laws. For a general overview of the American Legal System, see e.g. Toni M. Fine, American Legal Systems: A Resource and Reference Guide (LexisNexis 2008); Jack B. Jacobs, ‘Developing an Infrastructure for Hostile Takeovers: The Delaware Experience’ (2010) 2 UT Soft Law Review 10
the State level govern the takeover process and substantive rules, particularly in relation to takeover defences.\textsuperscript{142}

\textbf{2.1.2.1 Specific Rule-based Federal Law: The Williams Act 1968}

The US federal law governing takeovers can trace its roots to the use of tender offers as the primary takeover tool.\textsuperscript{143} As the use of cash consideration was generally permitted under the State merger statutes of the 1950s, the tender offer rapidly replaced the proxy contest as the main acquisition method for takeover bidders.\textsuperscript{144} For instance, only 8 tender offers involved companies listed on the New York Stock Exchange in 1960, while the number reached 107 in 1966.\textsuperscript{145} The total number of tender offers rose from seventy-nine from 1956-1960 to nearly twice that number from 1964-1966.\textsuperscript{146}

At that point, neither the Federal nor State law regulated tender offers.\textsuperscript{147} Consequently, the target shareholders were often coerced to accept tender offers without enough time or sufficient information to consider the offer. It was against this backdrop that the Williams Act was enacted in 1968 by the US federal government as the first piece of legislation regulating tender offers.\textsuperscript{148}

\begin{enumerate}
\item \textsuperscript{142} National security laws may also apply to a takeover should it threaten to impair national security. The Exon-Florio Amendment, 50 U.S.C. app. § 2170, passed in 1988 and amended in 1992, enables the President to block takeovers that threaten national security. The Committee on Foreign Investment in the United States (CFIUS) is also empowered to investigate and recommend action regarding to national security issues. Meanwhile, The Securities Act of 1934 and antitrust laws may also apply if the transaction involves competition issues. The Antitrust Division of the U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC) share responsibility for antitrust enforcement. Joy Dey, ‘Efficiency of Takeover Defence Regulations: A Critical Analysis of the Takeover Defence Regimes in Delaware and the UK’ (2009) Working Paper, Available at http://ssrn.com/abstract=1369542
\item \textsuperscript{143} Before then, most hostile takeovers were accomplished by replacing the target company board in a proxy contest. In that area the states did not play a significant role, because proxy contests were regulated under federal law, specifically, Section 14(a) of the Securities Exchange act of 1934 and the implementing proxy Rules promulgated by the US SEC. Jacobs, ‘Developing an Infrastructure for Hostile Takeovers: The Delaware Experience’ (2010) 2 UT Soft Law Review 10
\item \textsuperscript{147} Jacobs, ‘Developing an Infrastructure for Hostile Takeovers: The Delaware Experience’ (2010) 2 UT Soft Law Review 10
\end{enumerate}
The Williams Act was proposed by Senator Harrison A. Williams (D, NJ).\textsuperscript{149} It amends the Securities Exchange Act of 1934 by adding subsections (d) and (e) to Section 13 and subsections (d), (e) and (f) to Section 14.\textsuperscript{150} In promulgating the Williams Act, the US Federal Congress’ main aims are twofold: firstly, to ensure well informed decision-making by target shareholders; secondly, to ensure regulatory neutrality amongst the acquirer, the target board and target shareholders.\textsuperscript{151} These objectives are reassured in the case of \textit{Rondeau v. Mosinee Paper Corp.}\textsuperscript{152}

\begin{quote}
The purpose of the Williams Act is to insure that public shareholders, who are confronted with a cash tender offer for their stock, will not be required to respond without adequate information regarding the qualifications and intentions of the offering party.
\end{quote}

The Williams Act stipulates key rules governing information disclosure to target shareholders by a bidder or the target board, as well as a number of basic rules regarding the tender offers procedure, such as the timing of the offer and fair treatment of the securities holders. For example, Section 14(e) requires a true and complete statement in connection with “any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favour of any such offer, request, or invitation.”\textsuperscript{153}

As for the aim to create a level playing field among different participants, in reality, the Williams Act has constrained the acquirer much more than the target board and the shareholders. The imposed disclosure and procedural requirements under the Act not only deprived an acquirer of the former coercive tactics but also rendered tender offers more costly. Meanwhile, the disclosure and procedural requirements provided

\textsuperscript{149} Incorporated into the section 13 and section 14 of the Securities Exchange Act of 1934, the William Act is also called after the long title as: \textit{An Act Providing for Full Disclosure of Corporate Equity Ownership of Securities under the Securities Exchange Act of 1934}


\textsuperscript{151} As Senator Williams himself suggested, when drafting the Williams Act, extreme care had been taken to “avoid tipping the balance of regulation in favour of target management or in favour of the person making the takeover bid.” Instead, the Act is designed “solely to require full and fair disclosure for the benefit”. 113 Cong. Rec. 24, 664 (1967) (quoted in Schreiber v Burlington Northern 472 US 1 (1985), 8).

\textsuperscript{152} \textit{Rondeau v. Mosinee Paper Corp} US Supreme Court, [58]

\textsuperscript{153} Section 14(d)(7) and Rule 14d-10 of the Exchange Act, for another instance, provide for the best price rule, which requires that if a higher price is paid to some investors, the price of the offer, if lower, is aligned with this higher price. SEC Rule 14d-8 requires the pro rata acceptance of shares tendered if the offeror did not offer to buy all the tendered shares.

both target shareholders and the target board more information and time to respond to an offer. They would have more time to wage an effective campaign against an unsolicited offer.\textsuperscript{154}

\textbf{2.1.2.2 Specific Rule-based State Law: Anti-Takeover Statutes}

Since the federal law contributes only a small part of the takeover regulations focusing on information disclosure and procedure requirements, the state law retains the crucial task of providing substantive rules applicable in the tender offer context such as fiduciary duties of the target directors and the legitimacy of defensive measures.\textsuperscript{155}

The first part of the state law is the so-called Anti-Takeover Statutes. Most State legislators perceive that hostile bidders possess an unfair advantage in the bidding process and, therefore, target directors should be provided with broad discretion to counter these bidders.\textsuperscript{156} Accordingly, State legislators seek to ensure such discretion through the enactment of so-called “anti-takeover” statutes by imposing certain procedural and substantive requirements that create significant obstacles for bidders. These obstacles operate to either significantly impede, or totally prevent, unsolicited bids.\textsuperscript{157}

The Anti-Takeover State Statutes have evolved through three generations since the very first Virginia State Anti-Takeover Law in 1968.\textsuperscript{158} Most of the first and the


\textsuperscript{156} Forstinger, Takeover Law in the EU and the USA: A Comparative Analysis (Kluwer Law International 2002) Page 76

\textsuperscript{157} Differences between states abound, however, leading one commentator to observe that “[s]tate takeover acts are similar to snowflakes—if you think you have found identical ones, you are probably not looking closely enough.” However, some discussion of their key characteristics is necessary to complete the picture of US takeover regulation. Magnuson, ‘Takeover Regulation in the United States and Europe: An Institutional Approach’ (2009) 21 Pace International Law Review 205

\textsuperscript{158} Some authors argue that state takeover statutes have been passed in four, instead of three, generations. Thus, they see business combination statutes as the third generation and constituency statutes as the fourth generation of state takeover statutes. From a practical perspective, it does however not make a real difference if constituency statutes are categorized as the third or the fourth type of takeover law generations. The point is, that period of states’ activity enacting constituency statutes began in 1987.
second-generation State statutes were, however, struck down by federal courts due to the supremacy clause or the commerce clause of the US Constitution. For example, in the Mite case, the Illinois Business Takeover Act (the Illinois Act) is deemed to be incompatible with both constitutional provisions.

Firstly, the Illinois Act required bidders to notify the target and the Illinois Secretary of State twenty days before the offer’s effective date; secondly, the Illinois Act granted the Secretary of State to delay a tender offer by holding a hearing on the offer’s fairness and required the Secretary to hold such a hearing if shareholders owning 10% of the class of securities subject to the offer requested it; thirdly, the Illinois Act empowered the Secretary to enjoin an offer on various grounds, including substantive unfairness. Despite acknowledging that Illinois might have an interest in regulating tender offers, the US Supreme Court underlined the substantial burdens that the Illinois Act violates both the commerce clause and the supremacy clause.


One of the exceptions is with Indiana Control Share Acquisition Act. Despite the fact that both the federal district court and the Seventh Circuit Court of Appeals had invalidated the Indiana’s Control Share Acquisition Act, the Supreme Court upheld the Indiana Control Share Acquisition Act against the supremacy clause challenge and found that the Indiana Act did not violate the commerce clause, because, on the one hand, the Act applied equally to both interstate and local businesses; on the other hand, any burden on interstate commerce was outweighed by Indiana’s compelling interest in “defining the voting rights of shares of Indiana corporations”. CTS Corp. v. Dynamics Corp. of America US Supreme Court. See also Subramanian, Herscovici and Barbetta, ‘Is Delaware’s Antitakeover Statute Unconstitutional? Evidence from 1988-2008’ (2010) 65 Business Lawyer 685

Under the Supremacy Clause, federal law implicitly pre-empts a state statute if (a) compliance with both the federal law and the state law is impossible; or (b) the state statute frustrates the purposes of the federal law. Hines v. Davidowitz: 312 US 52, 61 S Ct 399, 85 L Ed 581 Supreme Court; Subramanian, Herscovici and Barbetta, ‘Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988-2008’ (2010) 65 Business Lawyer 685

Under the so-called “dormant” Commerce Clause, a state may regulate interstate commerce only if the state’s interest in regulating the commerce outweighs any adverse impact on interstate commerce. Pike v. Bruce Church, Inc US Supreme Court; Subramanian, Herscovici and Barbetta, ‘Is Delaware’s Antitakeover Statute Unconstitutional? Evidence from 1988-2008’ (2010) 65 Business Lawyer 685

See Fischel, ‘From MITE to CTS: State Anti-Takeover Statutes, the Williams Act, the Commerce Clause, and Insider Trading’ [1987] 1987 The Supreme Court Review 47; also Empire, Inc. v. Ashcroft F Supp Dist. Court, WD Missouri (invalidating the precommencement filing and hearing requirements of the Missouri takeover statute under both the supremacy and the commerce clauses).

Edgar v. Mite Corp. US The US Supreme Court

Justice White concluded:

“While protecting local investors is plainly a legitimate state objective, the State has no legitimate interest in protecting non-resident shareholders… It is also crystal clear that a major aspect of the effort to protect the investor in the Williams Act was to avoid favouring either management or the takeover bidder.” The Illinois Business Takeover Act upsets this balance: “By providing the target company with additional time within which to take steps to combat the offer, the pre-commencement notification provisions furnish incumbent management with a powerful tool to combat tender offers.”

Ibid
In response, States’ policy makers later promulgated the third-generation statutes to legalize defensive measures. (see Appendix 2.2 for the list of States adopting the third-generation statutes.) Research has suggested that more than forty States have adopted such a form of “expanded constituency” provisions. These provisions generally grant directors broad discretion to consider various constituencies’ interests in reaching takeover-related decisions. About 21 states have adopted the “pill endorsement” defensive provisions. These provisions afford legitimacy to the poison pill, which allows a target board to discriminate explicitly against unsolicited bidders. Meanwhile, other statutes have taken the form of statutory limitations on bidders’ actions.

2.1.2.3 General Standard-based Regulation: The Fiduciary Duties Applied by State Courts

Although both federal law and State statutes elaborate some basic rules with respect to takeover transactions, neither includes comprehensive rules to regulate the shift of

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168 There are three common statutes that limit the bidders: Control Share Acquisition Statutes typically allow a bidder to exercise his voting rights only after getting approval from the shareholders; Fair Price Statutes typically require the bidder to pay a certain price for the remaining shares to prevent the construction of a two-tier acquisition with a low back-end; and Business Combination Statutes typically prevent a bidder's whole acquisition of the firm (a freeze-out merger) for a certain amount of time. The last type was adopted by Delaware. Delaware adopted a relatively mild version of this statute (other states typically have a five-year limitation and the Delaware statute does not apply to a bidder that purchased 85% of the shares). Roberta Romano, ‘The Need for Competition in International Securities Regulation’ (2001) 2 Theoretical Inquiries in Law 1; Barzuza, ‘The State of State Antitakeover Law’ (2009) 95 Virginia Law Review 1973
corporate control as a result of takeovers, especially in relation to the allocation of decision-making rights over takeover defences. This is to be found within judicial applications of the general fiduciary standards by State courts.

It is well acknowledged that the courts of the State of Delaware developed case law which forms the primary source of the US regulation over the takeover market.170 Other States’ courts also frequently apply decisions of the Delaware courts to their decision-making on hostile takeover issues.171

Delaware case law has evolved under a unique institutional framework. Firstly, the Delaware executive branch headed by the State Governor has the least interest in becoming a prime actor in this arena. Hence, there was no administrative agency charged with regulating internal board conduct in Delaware 172 Secondly, the legislature has not been active in regulating takeover bids: the Delaware General Corporation law or other statutes do not address hostile takeovers, especially target board responding actions.173 As a consequence, the regulation of takeover transactions, especially anti-takeover defensive conduct by the target directors, has been left to the Delaware courts.174

Therefore court rulings in Delaware fill the gap created by the lack of federal and State legislative intervention in this area.175 As for rules governing the validity of defensive measures during the shift of corporate control, the Delaware courts have developed standards from applying the fiduciary duties in the case of *Unocal Corp. v.*

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172 The Delaware Secretary of State’s Office is partly involved into the corporate matters via its Division of Corporations. But this Division is merely responsible for filings required by law to be made with the Secretary of State and maintenance of the official records of all Delaware corporations and alternative entities. See further at Division of Corporations, ‘About Agency’ <http://corp.delaware.gov/aboutagency.shtml> accessed 20 February, 2015

173 Delaware adopted statutes restricting hostile takeovers, but its laws have been relatively mild compared with those of some other states. For example, Delaware’s second generation statute freezes business combinations for the relatively short period of three years and can be avoided altogether if the acquirer obtains 85% or more of the stock in the first stage of the acquisition. Geoffrey P. Miller, ‘Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England’ (1998) 1998 Columbia Business Law Review 51


The thrust of these standards is that directors have wide powers to resist a potential hostile takeover as long as they act in good faith and, after reasonable investigation, to take only proportionate measures. The detailed principles involved in those cases are elaborated in the subsequent section on substantive rules in the US.

2.1.3 Concluding Remarks

In summary, the UK and the US have presented two diverse frameworks of takeover regulation. In the UK, it is the Takeover Code, essentially a voluntary code of conduct, that provides the comprehensive source of law to regulate takeover transactions. In comparison, the US framework of takeover regulation combines the federal law and the State law. The federal law principally regulates the disclosure and procedure issues of a tender offer. Substantive rules, such as managers’ response to a takeover bid, primarily come from the State law, especially the State courts’ interpretation and application of the general standard of fiduciary duties.

An analysis of diverse features of different types of regulation frameworks is important. Whether a regulation framework is “rule-based” or “standard-based” will likely influence the principal regulatory institution responsible for administering these regulations. In addition, different forms of takeover regulation frameworks and regulatory institutions will then influence their substantive rules. As further discussed in the following sections, the “rule-based” Takeover Code defines the independent Takeover Panel system; together they produce a pro-shareholder style substantive rules in the UK; the “standard-based” application of general fiduciary duties demands judicial interpretation, which brings in its pro management type of substantive rules in the US.

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176 Unocal Corp. v. Mesa Petroleum Co. A 2d Del: Supreme Court, 1985
177 E.g., Revlon, Inc. v. MacAndrews & Forbes Holdings A 2d; Paramount Communications, Inc. v. Time Inc A 2d Del: Supreme Court, 1989; etc. These cases will be further discussed in the infra Section 2.3.2.
178 At times, these sources interact with one another; the interpretation of one body of law will influence the development of another, such as when the interpretation of the Williams Act prompted updates of State statutes from the ‘first generation’ to the subsequent generations. Armour and Skeel Jr, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of U.S. and U.K. Takeover Regulation’ (2007) 95 The Georgetown Law Journal 1727
2.2 Diverse Regulatory Institutions: Designated Regulatory Authority vs General Regulatory Authority

Regulatory institutions are authorities empowered by a regulation framework to administer and enforce substantive rules as prescribed within the regulation framework. As with the diverse takeover regulation frameworks, the organic nature and enforcing mechanisms of takeover regulatory institutions vary across jurisdictions. The predominant takeover regulatory institution in the UK is a centralized independent authority derived from an autonomous private agent. In contrast, the federal system in the US creates a dual level set of regulatory institutions where the general federal securities market regulator and the State Courts regulate different aspects of the takeover market.

2.2.1 The Designated Regulatory Authority System in the UK

The UK takeover regulatory authority system features an independent body, the Takeover Panel, which is designated to execute full jurisdiction over the UK takeover market. Other authorities such as the judiciary have played a very limited role regarding takeover regulations. The following sub-sections will examine roles and functions of these authorities.

2.2.1.1 Predominant Role of the Designated Takeover Panel

Shortly after the publication of the Takeover Code in 1968, a non-governmental body, namely the Takeover Panel, was established. The Takeover Panel was composed of representatives from private institutions involved in the takeover market. Its main designed functions are to administer the Takeover Code and to issue authoritative interpretations on its application to specific cases; to supervise and regulate takeovers and other matters to which the Takeover Code applies. Its central objective is to ensure fair treatment for all shareholders in takeover bids.

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181 Strictly speaking, one of the key institutions, namely the Bank of England, has been nationalized since 1946, although it had been a privately-owned institution since its establishment in 1694. Nevertheless, its operational independence and the UK central bank has not been changed but enshrined in the 1998 Bank of England Act. See a brief history of the Bank of England: http://www.bankofengland.co.uk/about/Pages/history/default.aspx#1. Also Richard Roberts and David Kynaston, The Bank of England : money, power, and influence 1694-1994 (Clarendon Press ; Oxford University Press 1995)

The other private institutions include: the London Stock Exchange, the Committee of London Clearing Banks, the British Insurance Association, the Association of Investment Trusts, the Accepting Houses Committee and the Issuing Houses Association

182 Introduction, The Takeover Code, Page A7-22
For many years, the Takeover Panel operated as a non-governmental body. and does not possess a direct statutory basis for enforcing the Takeover Code. Consequently, the Takeover Panel cannot enforce the substantive provisions of the Takeover Code through such statutory mechanisms as fines, injunctions, or ordering the payment of compensatory damages. Instead, the Takeover Panel issues formal public censures of violators alerting the financial community to the misconduct.¹⁸³

These censures are effective due to the close-knit nature of the City financial community, whereby a “cold shoudering”¹⁸⁴ mechanism ensures that the banking community and investors would refuse to deal with companies that violate the Takeover Code. This threat forces public companies to follow the Takeover Code otherwise they cannot obtain the services from, inter alia, investment bankers, which makes it difficult for companies to raise capital in the future.¹⁸⁵

The Panel and Code system has been praised as offering the advantages of speed, flexibility and low regulatory costs. Decisions are made quickly: normally immediately or within a matter of hours in the absence of an appeal to the Hearings Committee.¹⁸⁶ In 1987, Robert Alexander, Chairman of the Panel, explained the reason why non-statutory regulation has been successful under the Panel and Code system in his personal statement to the Panel’s Annual Report:¹⁸⁷

*It is sometimes said that the Panel lacks adequate power of sanction. In fact, ... almost all of those with whom the Panel deals are concerned to comply, and to be seen to comply, with the Code. This reflects in very great part the grave damage to the reputation of individuals, advisers and companies which would result from a breach of the Code or a failure to*

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¹⁸⁴ A firm must not act, or continue to act, for any person in connection with a transaction to which the Takeover Code applies if the firm has reasonable grounds for believing that the person in question, or his principal, is not complying or is not likely to comply with the Takeover Code. See MAR 4.3.1, Support of the Takeover Panel’s Functions, FSA: MAR Market Conduct


accept our decisions ... (and) the importance of co-operation between regulators.

This non-governmental regulatory approach formally changed in 2004, following the implementation of the EU Directive on Takeover Bids (2004/25/EC). The Takeover Directive, inter alia, requires Member States to designate the power to supervise takeover bids to public authorities, associations or private bodies recognised by national law or by public authorities expressly empowered for that purpose by national law. In transposing this requirement into the domestic law, the UK government places the Takeover Panel on a statutory footing.

Implementation in the UK is achieved in two stages. At the first stage, as the Company Law Reform Bill (the Bill) had not yet been enacted, implementation of the Directive was effected by means of secondary legislation (the Takeovers Directive (Interim Implementation) Regulations 2006 (SI 2006/1183)). At the second stage, the UK Parliament introduced Part 28 of the Companies Act 2006 as the extensive implementing framework. Chapter 1 of Part 28 of the Companies Act 2006 designates the Panel as the supervisory authority to continue its regulatory functions in relation to takeovers.

These provisions under the Companies Act 2006 are designed to ensure the continuance of the perceived advantages of an independent and self-regulatory approach: formulating its own rules, interpreting and applying those rules, as well as enforcing them on regulated entities. Thus, the Companies Act, by transposing the Takeover Directive, confers on the Panel the statutory support for core powers previously enjoyed by the Panel: (i) the “legislative power” to make rules for takeover transactions; (ii) the “judicial power” to interpret and apply those rules with binding

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189 The Regulations 2006, among others, designated the Panel on Takeovers and Mergers as the body to supervise takeover bids; made provision for the operation of regulatory activities of the Panel. It conferred on the Panel’s powers to require information (regulation 6) and to apply to the court to secure compliance with certain requirements (regulation 11). The Regulations also contained new offices in regulation 8 (the disclosure offense) and regulation 10 (failure to comply with rules about bid documentation). It further gave effect to the rules in the Takeover Code and the Rules of Procedure of the Panel’s Hearings Committee that implement the Directive. The Takeovers Directive (Interim Implementation) Regulations 2006
190 Chapter 1 of Part 28 of the Companies Act 2006 designates the Panel as the supervisory authority to continue its regulatory functions in relation to takeovers.
effects; (iii) the “administrative power” to give directions to secure compliance with the rules, or to require the disclosure of information. Under the Section 942 of the Companies Act 2006, the Takeover Panel may “do anything that it considers necessary or expedient for the purposes of, or in connection with, its functions.”

Perhaps the most significant change comes from the Companies Act 2006 that confers on the Panel a statutory sanction power for non-compliance with the takeover rules. As a self-regulatory body, the Panel previously had only limited formal sanctions such as private reprimands or public censure. In most cases, the Panel had to refer to the informal mechanism, namely “cold shouldering”, to report the offender’s conduct to a third-party authority who might take appropriate action against the offender.

Under the new statutory framework, the Takeover Panel can now require enforcement by the court (The High Court or Court of Session) where the Panel has established non-compliance. The court may then make any order it thinks fit to secure compliance with the requirement; this court order is supported by a potential charge of contempt of court if not followed. Additionally, the Takeover Panel can now impose compensatory damages on persons whose violation of a rule requires the payment of money.

The feature of the composition is probably the best way to illustrate the status of the Panel as a de facto self-regulatory body. The Companies Act 2006 does not regulate the composition of the Takeover Panel. It is, instead, the Takeover Code per se that prescribes the composition of the Takeover Panel. According to the Takeover Code, the Takeover Panel comprises up to 35 members, including a Chairman, up to 3 Deputy Chairmen, and up to another 20 members appointed by the Panel, and other individuals appointed by representative bodies of relevant market players involved in takeovers. The Panel appointees come from similar backgrounds as those of the

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193 Section 942 (2), Companies Act 2006
194 Davies and Worthington, Gower and Davies’ Principles of Modern Company Law (9 edn, Sweet & Maxwell 2012) Page 1020-1022
195 See supra footnote 184, and accompanying text
196 Section 955, Companies Act 2006
198 Introduction, The Takeover Code
199 These bodies include:
representative appointees, though they include a former general secretary of a large trade union.

The Takeover Panel operates through a number of Committees. For matters not dealt with through one of its Committees, the Takeover Panel is directly responsible. Among these committees, the Code Committee sets takeover rules as the Panel’s legislative branch. Meanwhile, the day-to-day work of takeover supervision and regulation falls to the Panel Executive. The Executive provides guidance on how the Code should be interpreted and applied to particular transactions. The responsibility of the Hearings Committee is to review rulings by the Executive as the Panel’s judicial branch; and also to hear disciplinary proceedings instituted by the Executive for a breach of the Code or of a ruling of the Executive or the Panel. Finally, the function of the Takeover Appeal Board, which is a separate organization from the Panel, is to hear appeals against decisions of the Hearings Committee.

2.2.1.2 Restrictive Role of the UK Courts

Towards the enforcement of the Code and the judicial review of the Panel’s operation, the UK courts have conventionally adopted a rather reluctant attitude to intervene. This attitude is very different from the active roles played by the US courts, especially the Delaware Court of Chancery.

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1) The Association for Financial Markets in Europe (with separate representation also for its Corporate Finance Committee and Securities Trading Committee)
2) The Association of British Insurers
3) The Association of Investment Companies
4) The British Bankers’ Association
5) The Confederation of British Industry
6) The Institute of Chartered Accountants in England and Wales
7) The Investment Association
8) The National Association of Pension Funds


It is solely responsible for keeping the Code under review and for proposing, consulting on, making and issuing amendments to the Code. Section 4(b), Introduction, The Takeover Code

In carrying out these functions, the Executive operates independently of the Panel. Section 5&6, Introduction, ibid. The Hearings Committee may also meet to consider a matter referred to it for review by the Executive or in other circumstances where the Executive or the Hearings Committee consider it appropriate to do so. Section 4(c), Section 7, Introduction, ibid.

The membership of the Takeover Appeals Board reflects the same three constituencies as the Panel and is chaired by a senior English judge. No person who is or has been a member of the Code Committee of the Takeover Panel may simultaneously or subsequently be a member of the Board. Section 8, Introduction, ibid.

The membership of the Takeover Appeals Board reflects the same three constituencies as the Panel and is chaired by a senior English judge. No person who is or has been a member of the Code Committee of the Takeover Panel may simultaneously or subsequently be a member of the Board. Section 8, Introduction, ibid.

Drayton, ‘Regulatory Structures: The Relationship Between the Takeover Panel, the FSA and the Courts’ in Payne (ed), Takeovers in English and German Law (Hart Publishing 2002)

See the supra Section 2.1.2.3, also the infra Section 2.2.2.2.
Shareholders in general have a clear interest in speedy regulatory decisions to resolve stock market uncertainties prompted by takeover bids.  

R (Datafin plc) v Panel for Takeovers and Mergers demonstrated that a judicial review by a UK court would not assess the Panel’s findings of fact but mainly examined issues around fair procedures, particularly whether the Panel had been acting in a manner consistent with “illegality”, “irrationality”, or “procedural propriety”. As Sir John Donaldson M.R. suggested:

"The only circumstances in which I would anticipate the use of the remedies of certiorari and mandamus would be in the event, which I hope is unthinkable, of the panel acting in breach of the rules of natural justice—in other words unfairly."

Moreover, the nature of the limited judicial review in the UK has appeared more historic rather than contemporaneous. In other words, the courts only intervene through declaratory orders after the conclusion of the bid, rather than intervening in the Panel’s decision during the course of that bid. Therefore, a target of a hostile takeover transaction would have little incentive to launch judicial review proceedings challenging the Panel’s decision.

This approach of the UK courts has been demonstrated in many other cases. In Guinness, for example, although the Court of Appeal condemned the Panel’s decision as “insensitive and unwise”, Lloyd L.J reaffirmed that the Court was “not concerned with the substantive decision” but “the decision-making process.”

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208 R (Datafin plc) v Panel for Takeovers and Mergers QB 815
209 Namely whether the panel has misdirected itself in law, ibid Page 18
210 Namely whether the panel’s decision is so outrageous in its defiance of logic or of accepted moral standards that no sensible person who had applied his mind to the question to be decided could have arrived at it, ibid Page 18
211 Namely a departure by the panel from any procedural rules governing its conduct or a failure to observe the basic rules of natural justice, which is probably better described as ‘fundamental unfairness’, since justice in nature is conspicuous by its absence, ibid Page 18
212 ibid
213 ibid
215 This case, according to Lloyd L.J., is the “only the second case in which a decision of a Panel on Take-overs and Mergers has been challenged in the courts.” R v Panel on Takeovers and Mergers ex parte Guinness plc QB 146
216 The Court of Appeal reviews the judicial jurisdiction and limitations in this case following the grounds set in Datafin, namely, “illegality, irrationality, procedural propriety and, possibly, proportionality”. The Jurisdiction of the Court, ibid
Fayed, again, the courts had the opportunity to intervene, but the Court of Appeal declined to grant an adjournment of the disciplinary proceedings.

As a consequence, the UK courts have not played as prominent a role as their US counterparts in the area of takeovers, despite the fact that numerous hostile takeover disputes in the UK may have provided many opportunities for authoritative judicial guidance on appropriate managerial conduct. For example, in the 1953 battle for the Savoy Hotel, the target management engaged in an egregious example of an asset lock-up defensive strategy, which stopped the putative acquisition deal in its tracks.

Rather than seek for judicial intervention, the bidder chose to push for a governmental inquiry, which produced only non-binding guidance on the duties of the target board. Indeed, not until the late 1960s and early 1970s did the British judiciary issue their first series of precedents on hostile takeovers, by which time the issue had largely been rendered moot by the introduction of the Takeover Code.

The UK courts have since been accommodating to the Panel system. A significant proportion of the regulatory issues arising in the UK takeovers regime are resolved by “no more than a telephone call to the Panel Executive.” This is why a significantly lower amount of takeover transactions have reached the UK courts when compared to the number in the US. As the following Table 2.1 illustrates, from 1990 to 2005, only 2 out of the 187 (or 0.1%) hostile takeover bids reached the UK courts.

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217 R v Panel on Takeovers and Mergers, Ex parte aL Fayed and Others BCLC 938
218 The court of appeal indicated the limited supervisory powers by way of judicial review, and suggested that “the executive's decision was not an adjudicative act”. Ibid
219 The bidder intended to, upon its successful acquisition, convert the Berkeley Hotel, one of the key assets of the target company, into commercial offices. As a response, the target management arranged for the Berkeley Hotel to be sold and leased back to the target company on terms that required it to be used as a hotel.
222 This difference was also due in great part to the different procedural rules that apply in the UK, including barriers to bringing class actions, the absence of a contingent fee system, and the “loser pays” attorneys’ fee rules. These procedural rules discouraged shareholders from bringing representative actions to enforce corporate and securities laws. One more variable is that the dominant shareholders in UK are institutional investors. They have not taken an active role in bringing derivative actions, since they do not want to incur the costs and inconvenience of derivative litigation, which tie up senior fund managers’ time, result in costs that cannot easily be passed on to fund clients, and invite free riding by other shareholders who do not contribute to the litigation. Miller, ‘Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England’ (1998) 1998 Columbia Business Law Review 51; Armour, Jacobs and Milhaupt, ‘The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework’ (2011) 52 The Harvard International Law Journal 219; Armour and Skeel Jr, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of U.S. and U.K. Takeover Regulation’ (2007) 95 The Georgetown Law Journal 1727
Meanwhile, during that same period, of the 312 hostile takeover bids of publicly traded target companies announced, 106, (or 33.9%), were litigated in the US.\textsuperscript{223}

\textit{Table 2.1, Takeover Litigations in the UK and the US from 1990-2005}

<table>
<thead>
<tr>
<th>Jurisdictions</th>
<th>Number of Hostile Takeovers</th>
<th>Number of Litigated Hostile Takeovers</th>
<th>Ratio of the Litigated Hostile Takeovers</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>187</td>
<td>2</td>
<td>1.07%</td>
</tr>
<tr>
<td>US</td>
<td>312</td>
<td>106</td>
<td>33.97%</td>
</tr>
</tbody>
</table>

Source: Adopted from Who Writes the Rules for Hostile Takeovers, and Why?\textsuperscript{224}

In accordance with the Company Act 2006 the Panel has been granted the status of statutory supervisor. Consequently the Panel, while having obtained the power to seek enforcement of its rulings by the courts, has also rendered its decisions to judicial review.\textsuperscript{225} Previously, the peculiar feature of the Panel as a non-statutory authority with a self-determined scope of activity was considered by Lord Woolf to be a major constraint on judicial intervention in the \textit{Guinness} case.\textsuperscript{226} The granting of the statutory footing has averred that there might be some potential for increased judicial interventions as the major constraint has been removed.\textsuperscript{227}

It remains to be seen whether there will be an increased willingness on the part of the UK courts to intervene in the Panel operation. Firstly, takeover issues are still a field within which the “Panel’s combined experience and expertise make it peculiarly well qualified to determine and in this field as a matter of substance and discretion the court should only interfere to avoid injustice.”\textsuperscript{228} Dealmakers in the UK are in fact forced to co-operate closely with the Panel, especially its Executive. For example,

\textsuperscript{225} Section 955, the UK Companies Act
\textsuperscript{226} “The Panel’s ability to carry on its activities without being subject to legal constraint or the intervention of the courts can however be limited by the nature of an activity which it undertakes… were carrying out that activity pursuant to a statutory duty. However, this does not mean the obligations are identical to those which would exist if it were under a statutory duty. In the normal case a body such as the Panel will retain a very wide discretion how it performs the task it sets itself and the court will regard its role as being one of last resort reserved for plain and obvious cases.” \textit{R v Panel on Takeovers and Mergers ex parte Guinness plc} QB 146
\textsuperscript{228} \textit{R v Panel on Takeovers and Mergers ex parte Guinness plc} QB 146; see also Kershaw, ‘Web Chapter: A The Market for Corporate Control’ in Kershaw (ed), \textit{Company Law in Context: Text and Materials} (2 edn, Oxford University Press 2012)
under the Code, directors bear an affirmative duty to seek guidance from the Panel, pursuant to a provision which demands that: “Any director who has a question concerning the propriety of any action as far as the Code is concerned should ensure that the Panel is consulted.” Therefore, the Panel retains significant powers and broad jurisdiction to control many aspects of takeover transactions.

Secondly, in implementing the 2004 EU Takeover Directive and placing the Panel and Code system on a statutory footing, the UK Companies Act 2006 empowers the Takeover Panel to issue statutory rules, and replicates, to the greatest extent possible, the Panel’s previous jurisdiction and practices. For example, the Panel has been conferred by the Companies Act the statutory power to supervise and make rules on takeovers, including similar rules in the Code. The Companies Act also ascertains that the Panel’s ruling has binding effect, and the Panel can make directions that must be complied with.

Thirdly, the UK courts, according to the UK Companies Act, have only limited powers of intervention toward the operational independence of the Takeover Panel by way of judicial review. Any possibility of tactical litigation by a party involved in a takeover battle is disabled. For example, it is prescribed that a party affected by the Panel’s decision must first go through a review process by the Panel’s Hearings Committee; if still not satisfied, then appeal to the Panel’s independent tribunal, the Takeover Appeal Board.

2.2.2 The General Regulatory Authority System in the US

In contrast to the designated independent system in the UK, in the US, the regulatory authority system features dual level of general regulators. On the federal level, it is the general securities market watchdog, the US Securities and Exchange Commission (SEC), regulating information disclosure and tender offer procedure requirement

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229 Appendix 3, Directors’ Responsibilities and Conflicts of Interest Guidance Note, The Takeover Code. See also Armour and Skeel Jr, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of U.S. and U.K. Takeover Regulation’ (2007) 95 The Georgetown Law Journal 1727, where the authors suggest that much of the communication with the Executive is very informal and most of the regulatory issues in deals are resolved with “no more than a telephone call.”


231 Section 942 & 943, The UK Companies Act 2006

232 Section 945 & 946, ibid

233 Section 956, ibid

234 Section 951(1), & 961 ibid
relevant to the takeover market; on the state level, it is general judicial adjudicators, in particular of the courts of Delaware, regulating substantive matters such as distribution of the decision power regarding anti-takeover measures. The following section will examine the functions of the SEC and the Delaware courts in relation to their administration of takeover regulations.

### 2.2.2.1 Roles of Federal Regulator: The SEC

The Williams Act 1968 is the main federal law regulating takeover transactions. But it is quite broad and ambiguous in certain respects such as fraudulent, deceptive, or manipulative practices. Therefore, further detailed rulemaking has been required to clarify these issues for the purpose of enforcement. This elaborating and enforcing power has mainly fallen to the SEC.

The SEC is created as an agency of the federal government in 1934, pursuant to the Section 4 of the Securities Exchange Act of 1934. The agency is headed by 5 Commissioners appointed by the US President and confirmed by the US Senate. To ensure Commissioners’ political neutrality, no more than 3 Commissioners shall be from the same political party. Apart from the Commissioners, the SEC consists of 5 Divisions and 23 Offices assuming various specialized responsibilities.

As a regulatory response to the Great Depression, the SEC’s mission is to administer the newly passed securities laws that aim to protect investors and to promote stability in the markets. Its functional responsibilities are broad, which include:

1. to interpret and enforce federal securities laws;
2. to issue new rules and amend existing rules;
3. to oversee the inspection of securities firms, brokers, investment advisers, and ratings agencies;

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235 Section 14(e), Securities Exchange Act of 1934; See generally also Thomas Lee Hazen, *The Law of Securities Regulation* (Thomson/West 2009)


237 Namely, the Securities Act of 1933 and the Securities Exchange Act of 1934. These securities laws, enacted during the peak year of the Depression, are designed to restore investor confidence in the capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing. See further on: The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation: [http://www.sec.gov/about/whatwedo.shtml#VPXuxVOsXgc](http://www.sec.gov/about/whatwedo.shtml#VPXuxVOsXgc). (Last accessed on 02 February 2015)

238 See further on the Section 4, the Securities Exchange Act of 1934
4) to oversee private regulatory organizations in the securities, accounting, and auditing fields; and

5) to coordinate U.S. securities regulation with federal, state, and foreign authorities.

In detail, the SEC, firstly, enjoys a delegated legislative power to interpret federal laws and develop new regulations when necessary. In furtherance of the implementation of the Williams Act, for example, the SEC has issued Regulation 13D\(^\text{239}\) pursuant to the Section 13 (d) of the Securities Exchange Act 1934. The Section 13 (d) requires the disclosure of important information by anyone seeking to acquire more than 5% of a company’s securities by direct purchase or tender offer.\(^\text{240}\) Regulation 13D further specifies the format and disclosure requirements for statements made on Schedule 13D and Schedule 13G.\(^\text{241}\) Outside of these formal regulations, the SEC also engages in adopting soft law by issuing concept releases,\(^\text{242}\) interpretive releases,\(^\text{243}\) policy statements\(^\text{244}\) and others\(^\text{245}\) to regulate the securities market.

The SEC, secondly, has the administrative power in enforcing the federal securities laws and its own rules, investigate and prosecute violations of relevant regulations. The Division of Corporation Finance of the SEC executes the responsibility to oversee corporate disclosure of important information to the investing public and to review documents that publicly-held companies are required to file with the SEC,


\(^\text{240}\) It proscribes, \textit{inter alia}, “Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class…or otherwise becomes or is deemed to become a beneficial owner of any of the foregoing upon the purchase or sale of a security-based swap that the Commission may define by rule, and is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition or within such shorter time as the Commission may establish by rule, file with the Commission, a statement…” Section 13(d)(1), Securities Exchange Act of 1934.

\(^\text{241}\) When a person or group of persons acquires beneficial ownership of more than 5% of a voting class of a company’ equity securities registered under Section 12 of the Securities Exchange Act of 1934, they are required to file a Schedule 13D with the SEC. See further on Compliance and Disclosure Interpretations: [http://www.sec.gov/divisions/corpfin/cfguidance.shtml](http://www.sec.gov/divisions/corpfin/cfguidance.shtml).

\(^\text{242}\) The Concept Releases have been occasionally published to solicit the public’s views on securities issues so that SEC can better evaluate the need for future rulemaking. See SEC Concept Releases: [http://www.sec.gov/rules/concept.shtml](http://www.sec.gov/rules/concept.shtml).

\(^\text{243}\) SEC Interpretive Releases include SEC’s views and interpretation of the federal securities laws and SEC regulations. They are occasionally provided as the guidance on topics of general interest to the business and investment communities. See SEC Interpretive Releases: [http://www.sec.gov/rules/interp.shtml](http://www.sec.gov/rules/interp.shtml).


such as documents concerning tender offers, filings related to mergers and acquisitions, or proxy materials sent to shareholders before an annual meeting.\textsuperscript{246}

The Division of Enforcement enjoys another enforcement power. It executes its law enforcement function by recommending the commencement of investigations of securities law violations, by suggesting civil actions in federal court or as administrative proceedings before an administrative law judge, and by prosecuting these cases on behalf of the SEC.\textsuperscript{247}

As for the judicial power, the SEC’s Office of Administrative Law Judges consists of independent judicial officers who conduct hearings and rule on allegations of securities law violations in cases initiated by the SEC. When the SEC initiates a public administrative proceeding, it refers the cases to the Office, where it is assigned to an individual Administrative Law Judge (ALJ). The ALJ then conducts a public hearing that is similar to a non-jury trial in the federal courts.

Just as a federal judge has powers, an ALJ issues subpoenas, rules on motions, and rules on the admissibility of evidence. At the conclusion of the hearing, the parties submit proposed findings of fact and conclusions of law. The ALJ prepares an initial decision that includes factual findings and legal conclusions that are matters of public record. Parties may appeal an initial decision to the SEC, which can affirm, reverse, modify, set aside or remand for further proceedings. Appeals from SEC action are to a US Court of Appeals.\textsuperscript{248}

In brief, the SEC shares the similar delegated legislative power, administrative power, and quasi-judicial power in administer the federal takeover rules as enjoyed by its UK counterpart, namely, the Takeover Panel. But the breath of their power differs. The UK Takeover Panel has the full authority to develop the Takeover Code; the US SEC has to adhere to the federal laws. Moreover, the SEC is established as the primary federal agency empowered with a broad jurisdiction over the general securities

\textsuperscript{246} See further on: About the Division of Corporation Finance, \url{http://www.sec.gov/divisions/corpfin/cfabout.shtml#VPYwZ1OxsXgc}. (Last accessed on 03 February 2017)

\textsuperscript{247} See further on: About the Division of Enforcement, \url{http://www.sec.gov/divisions/enforce/about.htm#VPYxv1OxsXgc}. (Last accessed on 03 February 2017)

\textsuperscript{248} See further on: Office of Administrative Law Judges, \url{http://www.sec.gov/alj#VPYy5FXsXgc}. (Last accessed on 03 February 2017)
market. In contrast, its UK counterpart, i.e., the Takeover Panel, is solely created as a special autonomous body to regulate the takeover market.

### 2.2.2.2 Roles of State Regulator: The Delaware Court

Regulation of substantive matters in takeover transactions are established by the judicial applications of the general fiduciary standards in state courts. Among other states courts, the Delaware courts, in particular, the Court of Chancery, have provided the primary source of regulation for target directors’ decision-making toward an unfriendly takeover bid.

Indeed, the Court of Chancery of the State of Delaware has presented itself as “an integral part of the Delaware brand” to attract a majority of large publicly traded corporations to incorporate in Delaware. For example, more than 1,000,000 business entities have their legal home in Delaware, among which are more than 50% of all US publicly-traded companies and 64% of the Fortune 500. Moreover, the Delaware courts’ rulings have carried influence on control shifts beyond the borders of the Delaware State: courts of other States also frequently apply decisions of the Delaware courts to their own corporate decisions.

The Delaware Court of Chancery prestige as the main regulator governing substantive takeover matters derives from a unique institutional framework. Created in 1792 as a separate court to deal with matters of equity, the Court of Chancery has no jurisdiction over criminal and tort cases that create “huge backlogs in other judicial systems”. Hence the Court of Chancery is able to process more corporate litigation.

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249 Section 4, Securities Exchange Act of 1934
252 Forstinger, Takeover Law in the EU and the USA: A Comparative Analysis (Kluwer Law International 2002)
255 Although the Court is prominent in deciding corporate law matters, it continue functioning as a traditional court of equity. For instance, the Court still issues injunctions in noncorporate matters as decided in the case of Mummert v. Wiggin A 2d Del: 1992.
and to grow a better reputation for expertise in corporation law matters. As the Chief Justice William Rehnquist of the US Supreme Court has noted:\footnote{Recited from ibid}

\textit{Corporate lawyers across the United States have praised the expertise of the Court of Chancery, noting that since the turn of the century, it has handed down thousands of opinions interpreting virtually every provision of Delaware’s corporate law statute. No other state court can make such a claim. As one scholar has observed, “the economies of scale, created by the high volume of corporate litigation in Delaware, contribute to an efficient and expert court system and bar.”}

To regulate anti-takeover defensive conduct, the Delaware Court of Chancery’s basic approach is to apply a fiduciary duty concept, as developed under the common law, on a case by case basis. Under this approach, the validity of defensive measures are determined under standards developed according to the fiduciary duties by the Delaware Supreme Court in \textit{Unocal Corp. v. Mesa Petroleum Co.} and its progeny.\footnote{Unocal Corp. v. Mesa Petroleum Co. A 2d Del: Supreme Court, 1985} Thus, the key feature of US takeover regulatory pattern is the Delaware approach, namely, a court-centred system relying on general standards of fiduciary duties to review the defensive actions by the target board against unsolicited bids for corporate control.

The thrust of these principles is that directors have wide powers to resist a potential hostile takeover as long as they act in good faith and after reasonable investigation to take only proportionate measures.\footnote{Dey, ‘Efficiency of Takeover Defence Regulations: A Critical Analysis of the Takeover Defence Regimes in Delaware and the UK’ (2009) Working Paper, Available at http://ssrn.com/abstract=1369542} By providing pro-managers judgments and framing rules to reinforce the management interest, court rulings in Delaware fill the gap created by the lack of intervention by other federal and state agencies.\footnote{E.g., Revlon, Inc. v. MacAndrews & Forbes Holdings A 2d: Paramount Communications, Inc. v. Time Inc A 2d Del: Supreme Court, 1989; etc. These cases will be further discussed in the following section on US Joint Decision-making Rule.} The detailed principles involved in those cases are elaborated in the following section about the substantive rules in the US.
2.2.3 Concluding Remarks

In summary, takeover regulatory institutions in the UK and the US have embodied diverse characteristics. The defining characteristic of the UK takeover regulatory institution is its independency from governmental and judicial intervention. The UK judiciary has persistently demonstrated little intention to intervene the Panel’s jurisdiction. The UK Panel and Code system until very recently was entirely self-regulatory, both *de jure* and *de facto*. Even though the implementation of the 2004 EU Takeover Directive and the promulgation of Companies Act 2006 have, *de jure*, altered the Takeover Panel from a self-regulatory base to a statutory body; the essential features underpinning the Panel system persist, as the transition has been designed with an express objective of maintaining its independent approach.\(^{262}\) The development, interpretation and enforcement of the Takeover Code remains squarely within the control of the Panel.\(^{263}\)

By contrast, the US takeover regulatory institutions feature a general federal governmental agency and the strong State judicial influence in the enforcement and the development of takeover rules. The SEC, as an agency of the federal government, has a broad jurisdiction over the US securities market. But it does not have the full authority over the takeover market as its UK counterpart does. Instead, its main jurisdictions in relations to the takeover transactions are limited to matters such as the procedure of tender offer and the disclosure of information. Substantive rules such as either the board or the shareholder has the decision power to initiate takeover defences are left to judicial decisions. In the State lever, the Delaware Court has played a significant role in developing the takeover rules by developing the general standard of fiduciary duties to deciding takeover cases.

2.3 Diverse Substantive Rules: Pro-Shareholder Orientation vs Pro-Management Orientation

This section will compare the UK takeover substantive rules with the US ones. A takeover transaction, especially a hostile one, may constitute a source of great


\(^{263}\) The general principle is that the court will interrupt the Panel’s enormously wide self-regulatory discretion only for the purpose of public interests. *R (Datafin plc) v Panel for Takeovers and Mergers* QB 815; also Rosenzweig, ‘Private Versus Public Regulation: A Comparative Analysis of British and American Takeover Controls’ (2007) 18 Duke Journal of Comparative & International Law 213
divergence of interests between target managers and shareholders. Certain policy issues hence arise such as to who, shareholders or directors, shall have the decision power regarding whether or not to bargain with the bidder; whether or not to reject the offer; and whether or not to adopt takeover defences. Resolutions are needed to govern the behaviour of shareholders and management.

The first resolution is a pro-shareholder approach. It proposes to suspend the agency relationship between shareholders and directors, to transfer the decision power on acceptance of a takeover bid from the directors to the shareholders of the target company. This would have the effect of allocating the decision-making on shift of control exclusively to the shareholders by depriving the directors of their managing role in the interactions between the acquirer and target shareholders. In this instance, the shareholders, as the principal, become decision-makers. The directors may only take limited actions to influence the shareholders’ decision, such as to advise the target shareholders to reject the bid, or to search for “white knights” to advance a bid competition.

The second resolution is a pro-management approach. It proposes to provide a target board with the flexible power to negotiate with a bidder on behalf of the shareholders and substantial decision-making power to unilaterally take defensive measures against unsolicited bids. This resolution renders the decision-making process subject to the joint consent of both the target board and the target shareholders. The acquirer needs to negotiate with both target shareholders and the target board to obtain their consent with the sale of the target company.

Both resolutions have intrinsic merits and costs. The first approach addresses better the agency problems between the shareholders and management of the target, but it subjects the interest of dispersed shareholders to collective problems and it normally applies only after a bid has become foreseeable for the target board or made public by

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264 Although it can also function as an external corporate governance mechanism to align managers to act in the interests of the shareholders. Goergen, Martynova and Renneboog, ‘Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe’ (2005) 21 Oxford Review of Economic Policy 243 See further in the supra Section 1.2.1, Chapter 1.

265 Ibid

266 The potential gains from the control shift may now have to be split three ways (acquirer, target shareholders, target management) and, to the extent that the benefits to management of their continuing control of the target company exceed any share of the gain from the control shift which the acquirer is able or willing to allocate to them, fewer control shifts will occur. Kraakman and others, The Anatomy of Corporate Law: A Comparative and Functional Approach (2 edn, Oxford University Press 2009)
a bidder. The second resolution offers management the flexibility to protect non-shareholders’ interests and to combat value-destroying takeovers, but it creates risks of management’ abuse of defensive measures in pursuing self-interests in detrimental to the shareholders’ interests.

Legal strategies should be deployed to enhance the merits and to mitigate the potential costs. For the first resolution, regulatory measures such as the mandatory bid rule have been availed to ensure the equal treatment of shareholders.\(^{267}\) Meanwhile, disclosure requirements have been imposed to inform potential target shareholders with the threatened takeover bid.\(^{268}\) For the second resolution, complementary measures have been initiated to align managerial interests with those of the shareholders, such as the *ex post* scrutiny by a court applying the fiduciary duties to directors, or the use of executive compensation schemes.\(^{269}\)

Different resolutions have been adopted by policy makers.\(^{270}\) The first resolution is adopted in the UK and in most Continental European countries: where nineteen Member States have transposed the board neutrality rule;\(^{271}\) three Member States

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\(^{267}\) In brief, the Mandatory Bid Rule (MBR) mandates that a shareholder who has acquired certain percentage of shares to make an general offer for the remaining shares at a fair price. The Mandatory Bid Rule is considered to be capable of providing a great degree of equal treatment amongst all target shareholders, since the control premium is shared amongst all shareholders. However, the Rule is often criticised for preventing value increasing transactions. See also Schuster, ‘The Mandatory Bid Rule: Efficient, After All?’ 76 The Modern Law Review 529


\(^{269}\) For example, many jurisdictions now request the beneficial owners, whether acting alone or in concert, to disclose the fact of their ownership when certain threshold (normally 5%) is meet, and their intentions regarding the control of the company. See further in Kraakman and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2 edn, Oxford University Press 2009) Page 236


\(^{271}\) The two solutions have implications not only in terms of the relative importance of agency problems and the development of the market for corporate control, but also in terms of ownership. Roe predicts that, under the second solution, ownership may become more concentrated, as management has substantial discretion to apply anti-takeover measures and costs associated with managerial discretion arc high. If ownership is concentrated, the first solution may encourage better minority shareholder protection as it reduces the power of the managers acting in the interests of the large blockholder. In this case, ownership is likely to become more dispersed. However, this may be true only if the voting power of the controlling blockholder is also restricted. Otherwise, ownership will become even more entrenched in the hands of the controlling blockholder as he will have power to affect any corporate decisions, not through management but directly. Mark J. Roe, ‘Political Preconditions to Separating Ownership from Corporate Control’ (2000) 53 Stanford Law Review 539; Goergen, Martynova and Renneboog, ‘Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe’ (2005) 21 Oxford Review of Economic Policy 243

have transposed the breakthrough rule; 272 and thirteen Member States have transposed the reciprocity rule by 2012.273 At the same time, the US, and other countries like the Netherlands implement the second solution: a target board may unilaterally take defensive measures against the offer with an ex post assessment of fiduciary duties by the courts. 274 The following sections examine the policy implementation of both resolutions in the UK and the US, respectively.

2.3.1 The UK Pro-Shareholder Approach

This section will examine the Non-Frustration Rule in the UK Takeover Code and its reflective, namely, the Board Neutrality Rules as adopted by the EU Takeover Directive.

2.3.1.1 The UK Non-Frustration Rule

Introduced in the Takeover Code, the non-frustration rule was initially set to counteract abuses of board power to issue shares with the purpose of fending off unwarranted bids in the 1950s and 1960s.275 Under the Principle 3 of the Takeover Code, “The board of a target company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid.”276

This Principle 3 is further elaborated under the Rule 21: Restrictions on Frustrating Action of the Takeover Code. The Rule 21 reiterates the general prohibition on frustrating board actions when an offer has been announced or is imminent. A target board, without the approval of the shareholders in general meeting, is not permitted to take any action which might result in a bona fide offer being frustrated, or in the

272 They are Estonia, Latvia and Lithuania.

The breakthrough rule (Article 11 of the Directive) neutralises pre-bid defences during a takeover by making certain restrictions (e.g. share transfer or voting restrictions) inoperable during the takeover period and allows a successful offeror to remove the incumbent board of the offeree company and modify its articles of association.

273 They are Belgium, Denmark, France, Germany, Greece, Hungary, Italy, Luxembourg, the Netherlands, Poland, Portugal, Slovenia and Spain.

The rule, in accordance with article 12 (3) of the Directive, allows companies who are subject to the board neutrality rule and/or breakthrough rule (by law or based on the articles of association of the company) not to apply the rule when they are confronted with a takeover bid by an offeror who is not subject to the same rule.


276 General Principle 3, The Takeover Code
shareholders of the target company being denied the opportunity to decide on its merits.\textsuperscript{277}

The prohibition of certain board activities is based on the criteria of the objective deterring effect of frustrating actions; rather than the subjective intentions or motives of the target board.\textsuperscript{278} Rule 21 provides a detailed list of prohibited board actions:\textsuperscript{279}

\begin{enumerate}
\item to issue any shares or transfer or sell, or agree to transfer or sell, any shares out of treasury;
\item to issue or grant options in respect of any unissued shares;
\item to create or issue, or permit the creation or issue of, any securities carrying rights of conversion into or subscription for shares;
\item to sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount; or
\item to enter into contracts otherwise than in the ordinary course of business.
\end{enumerate}

The consent of the shareholders in general meeting must be attained if the board of directors intends to engage in any of these activities. In addition, the Panel must be consulted in advance if the board has any doubts as to whether an action does fall within this Rule or not.\textsuperscript{280}

The non-frustration rule does not mean that the target board should remain totally inactive when facing a hostile offer. On the contrary, the target board is obliged to secure competent independent advice on any offer and to make such advice known to its shareholders.\textsuperscript{281} The advice must include views on, \textit{inter alia}, the effects of implementation of the bid on the future prospectus of the company, on employment levels, and on the locations of the company’s places of business.\textsuperscript{282} Furthermore, certain other measures that enhance the interests of the target shareholders but may impede an unsolicited offer are even encouraged. For example, the target board has

\begin{footnotesize}
\textsuperscript{277} Rule 21, ibid
\textsuperscript{278} Gerner-Beuerle, Kershaw and Solinas, ‘Is the Board Neutrality Rule Trivial? Amnesia about Corporate Law in European Takeover Regulation’ (2011) 22 European Business Law Review 559
\textsuperscript{279} Rule 21, The Takeover Code
\textsuperscript{280} Rule 21, ibid
\textsuperscript{281} Rule 3, ibid
\textsuperscript{282} General Principle 2, ibid.
\end{footnotesize}
the obligation to seek competing bids offering higher premiums, on the condition of a equal treatment of the competing bidders.283

The scope of the no frustration rule appears limited. As under the Takeover Code, the principle becomes applicable only when a bid either has been announced or become imminent to the knowledge of the target board.284 Nevertheless, both the UK general corporate rules and the ownership structure controlled by institutional shareholders have restricted the use of *ex ante* embedded defensive tactics in a broad way.285

An example is the poison pill, which is subscribed to as one of the most popular *ex ante* defensive tactics used by the American companies.286 But the poison pill could not be implemented in UK: the Companies Act 2006 requires general shareholder meetings to approve the new shares issuance.287 The strong force of a staggered board measure is also invalidated in the UK due to a combination of two general corporate rules.288 The first reason is the mandatory provision on members’ approval of the directors’ remuneration report;289 the second reason is the mandatory rule that shareholders can remove directors by an ordinary resolution at any time prior to the expiration of their period of office.290

The case law in the UK also emphasizes that the ultimate decision on takeovers should rest with the shareholders, not with the incumbent managers. It holds that management actions that seek to defeat the shareholder control over the defensive

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283 Rule 20, 21, ibid
284 Rule 21.1, ibid
285 “Embedded defences” could range from the fairly transparent, such as the issuance of dual-class voting stock, adopting a staggered board appointment procedure, or the use of “golden shares” or generous golden parachute provisions for managers to the more deeply embedded, such as provisions in bond issues or licensing agreements that provide for acceleration or termination if there is a change of control. See Armour and Skeel Jr, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of U.S. and U.K. Takeover Regulation’ (2007) 95 The Georgetown Law Journal 1727; also David Kershaw, ‘The Illusion of Importance: Reconsidering the UK’s Takeover Defence Prohibition’ (2007) 56 International and Comparative Law Quarterly 267
287 The authorisation by the shareholder meeting of the power of directors to allot shares may: (a) be renewed or further renewed by resolution of the company for a further period not exceeding five years, and (b) be revoked or varied at any time by resolution of the company. Section 551 (4), The UK Companies Act 2006. See a thorough discussion of the limitation imposed by general corporate rules on the board discretion in Kershaw, ‘The Illusion of Importance: Reconsidering the UK’s Takeover Defence Prohibition’ (2007) 56 International and Comparative Law Quarterly 267
289 Section 439, 440, The UK Companies Act 2006
290 Section 168, ibid
measures fall outside the scope of delegated management authority. In *Hogg v. Cramphorn Ltd*,\(^{291}\) for example, the directors adopted the defensive strategy of creating a trust for the benefit of the employees, and transferring a substantial number of shares to the trust to ensure that they would control a majority of the target’s stock. This strategy was ruled voidable, since it had not gained the consent of the shareholders in general meeting. For another example, in *Criterion Properties Plc v. Stratford UK Properties LLC*,\(^{292}\) the court held that a poison pill strategy deployed by the management of a company to thwart an unsolicited third-party bid was invalid insofar as it was not in the commercial interests of the shareholders; and in breach of the management’s fiduciary duties to the company.

### 2.3.1.2 The Board Neutrality Rule: The Spill-over Effect of the UK Non-Frustration Rule in the Takeover Directive

The UK non-frustration rule has also influenced the formulation of the board neutrality rule as prescribed under the 2004 EU Takeover Directive.\(^ {293}\) In the Takeover Directive, the board neutrality rule is presented as an optional rule, which a Member State can choose whether or not to transpose it into its domestic law.\(^ {294}\) The rule has now been widely adopted by EU countries following the implementation of the Takeover Directive. Nineteen Member States so far have transposed the board neutrality rule, according to a survey on the implementation of the Takeover Directive.\(^ {295}\)

The Takeover Directive stipulates that, as one of its six principles, the powers of the board of the target company to engage in operations of an exceptional nature should be limited so as not to frustrate a *bona fide* bid, without unduly hindering the target

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\(^{291}\) *Hogg v. Cramphorn Ltd* Ch 254

\(^{292}\) *Criterion Properties Plc v. Stratford UK Properties LLC* UKHL 28


company in carrying on its normal business activities. Following this principle, Article 3(c) of the Takeover Directive mandates the target board to act in the interests of the company as a whole and not to deny the holders of securities an opportunity to decide on the merits of the bid.

Article 9.2, 9.3 and 9.4 of the Takeover Directive further require the target board to remain passive during a takeover attempt. That is, the target board is not permitted — without the consent of the shareholders — to do more than informing the shareholders about the bid and its merits. Article 9.5 further prescribes the details of the opinion that the target board must present concerning a bid to target shareholders and employees. The permissible action as an exception to this passivity rule, similar to the Takeover Code, is that the board may actively seek to identify other bidders, for the purposes of ensuring that the target shareholders secure as high a price as possible.

The Takeover Directive further introduces an innovative “break-through” rule to lower barriers to an active takeover market. It aims to break-through restrictions (i) on transferability of target securities in respect of acceptances of a bid and the bidder’s market purchases during the course of an offer; (ii) on voting and any multiple voting rights in relation to votes on frustrating measures during the course of an offer; and (iii) on share transferability or voting rights following a bidder acquiring 75% or more of the shares carrying voting rights.

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297 The board of the offeree company is also required to give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company’s places of business. Article 3, ibid
298 Article 9, ibid; also Whereas 17, ibid
This is for the purpose of creating favourable conditions for the further integration of an European securities market through takeover bids and a level playing field in the area of takeover bids among member states. See Summary of the High Level Group of Company Law Experts’ Observations and Recommendations, Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids (Brussels, 10 January 2002, 2002) 2
302 Article 11 (3), ibid
303 It also suspends the use of any extraordinary rights of shareholders concerning the appointment or removal of board members provided in the articles of association of the offeree company. Article 11 (4), ibid
2.3.2 The US Pro-Management Approach

The Williams Act of 1968 and the SEC implementing rules mainly regulate the procedural fairness of a tender offer, requiring the offer to remain open for twenty days; tendered shares to be accepted by the bidder on a pro rata, rather than “first-come-first-served”, basis; and certain disclosures to be made to shareholders by both the bidder and the target company, etc. They neither encourage nor prohibit a target board from taking measures to fend off unsolicited tender offers.

It is State legislatures and State courts that have erected a plethora of barriers to the commencement of takeovers, especially those unsolicited offers. On the one hand, anti-takeover statutes have inserted various anti-takeover provisions against unfriendly bidders; on the other hand, the courts have adjudicated in favour of a wide discretion for the target board. As a result, the management is granted wide discretion to implement defensive measures, as long as they comply with the company’s charter documents and their fiduciary duties as interpreted by the courts.

The above section 2.1.2.2 on the anti-takeover statutes has discussed provisions such as the “expanded constituency” provision, the “pill endorsement” defensive provision, and other forms of statutory limitations on bidders’ actions. The following section will examine the pro-management approach as reflected in the case law system as developed by Delaware courts. The leading US corporate law jurisdiction, the Delaware courts have developed a series of standards to regulate actions of the target board in response to hostile takeovers. Based on the interpretation of the general fiduciary duties, these standards have “completed the landscape of American tender offer regulation”.

2.3.2.1 The Business Judgement Rule

When deciding whether a board properly exercises their fiduciary duties in face of an unsolicited bid, the US courts have applied the so-called “Business Judgement Rule”.

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304 Section 13 & 14, Stock Exchange Act of 1934
307 The above Footnote 60 – 64 and accompanying text.
A classic definition of the “Business Judgement Rule” is given as a presumption that “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” 309

A hallmark of the Business Judgement Rule is that a court will not substitute its judgment for that of the board if the latter’s decision can be attributed to any rational business objective.310 A board hence is not liable for a mistake in business judgement once it can be established that the board make the decision in good faith and they believe that the decision is in the best interest of the company.311

Pursuant to the “Business Judgement Rule”, the Delaware courts have bestowed directors of target corporations with a wide variety of defensive measures to impede hostile takeover bids.312 But the courts have realised the risks of managers abusing their wide powers for selfish purposes also need to be controlled. Therefore, the Delaware courts have developed a series of standards through Unocal Corp. v. Mesa Petroleum Co.313 and its progeny,314 in order to determine the validity of anti-takeover measures and prevent the target management from abusing their discretion to launch anti-takeover measures to the detriment of the target shareholders.315

2.3.2.2 The Unocal Standard

Under the case of Unocal Corp. v. Mesa Petroleum Co.,316 the Delaware Supreme Court established a general principle that the target board has a responsibility to assess whether an offer is in the best interests of the target firm and its shareholders. More importantly, the Court elaborates several standards, also known as the “Unocal Test”, concerning judicial review of defensive tactics mounted by the target directors.

309 See Aronson v. Lewis A 2d Del: Supreme Court
310 See Sinclair Oil Corporation v. Leven A 2d Del: Supreme Court
311 See e.g., AC Acquisitions Corp v Anderson, Clayton & Co 519 A 2d 103 (Del Ch 1986), 111.
313 Some states, such as Maryland, have rejected the Unocal line of cases and have adopted an extreme version of the just-say-no defense. The Maryland Unsolicited Takeover Act specifically discards the Delaware courts’ heightened scrutiny of directors’ decisions to reject takeover bids. Rather, the act states explicitly that the actions of the directors of Mary land corporations will be measured under the Business Judgement Rule and may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director. See Berick and Shropshire, ‘Chapter 4, The EU Takeover Directive in Context: A Comparison to the US Takeover Rules’ in Hooghten (ed), The European Takeover Directive and Its Implementation (Oxford University Press 2009)
314 See the following discussion on the progeny.
316 Unocal Corp. v. Mesa Petroleum Co. A 2d Del: Supreme Court, 1985
against unsolicited take-over bids: (i) whether directors, with reasonable grounds, perceive a threat to corporate policy or effectiveness by a takeover bid, and (ii) whether the defensive measures used are proportionate and reasonable given the nature of the threat.317

A court can invalidate a defensive measure that does not meet the “Unocal Test”. The invalidation could be based on a finding that such as a bid does not appear to threaten the corporation, its shareholders or non-shareholder constituencies; or the costs of the defensive measure are not proportionated to counter the takeover bid for the corporation or its shareholders.318

2.3.2.3 The Revlon Standard

The Revlon Standard appears to be more restrictive to the target management. In the case of Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,319 the Unocal Standard changes under circumstances where either the “sale” or “break-up” of the company is perceived inevitable by the board, or the board takes the initiative to put the corporation up for sale. such as a merger with a white knight, a leveraged buyout or a sale of substantially all the corporation’s assets.320

In either circumstance, a corporation is deemed to be in the “Revlon mode” where the fiduciary duty of the target directors becomes an “auction duty” to secure the highest price for the shareholders. 321 The role of the target board transforms from “defenders of the corporate bastion” to “auctioneers charged with getting the best price for the stockholders at a sale of the company.” 322 Accordingly, a defensive measure permitted by the Unocal Standard may become a breach of directors’ fiduciary duty according the Revlon Standard.323

317 Ibid
319 Revlon, Inc. v. MacAndrews & Forbes Holdings A 2d
321 Revlon, Inc. v. MacAndrews & Forbes Holdings A 2d Page 176
322 Ibid
2.3.2.4 The Paramount Standard

The case of Paramount Communications, Inc. v. Time Inc. marks a retreat from intense judicial scrutiny of defensive tactics. The Paramount decision leans heavily toward a directors’ discretion position. It allows Time Inc. to complete a strategic merger with Warner, which the board of Time deemed was in the best long-term interests of its shareholders; despite the Paramount offer at a substantial premium.

This decision thus tilts the balance strongly toward management discretion and away from shareholder choice: “Fending off a hostile takeover, when done to protect a deliberately conceived corporate plan, is part and parcel of a board’s authority over a corporation’s business and affairs.” In the wake of this decision it seems that directors can hide behind such defensive mechanisms as poison pill, since the court allows managers to “just say no” when they face a hostile bid.

The federal courts have also supported this judiciary choice leaning toward the principle of director primacy. In Moore Corp. Ltd. v. Wallace Computer Services, Inc. Case, the US District Court for the District of Delaware interpreted Delaware law and upheld the defensive tactics, since it was satisfied that the Unocal/Revlon standards were met and observed that the offer was neither adequate nor in the interest of the target, even after a majority of shareholders tendered their shares.

2.3.2.5 Recent Cases

Recent cases ruled by the Delaware courts reaffirm their traditional deference to the pro management approach. For example, on August 12, 2010, Vice Chancellor Strine of the Court of Chancery, in Yucaipa American Alliance Fund II, L.P. v. Riggio, upheld the use of a poison pill because: (i) the board made a good faith and
reasonable determination that Yucaipa posed a threat; and (ii) the rights plan was a proportionate response to the threat the company faced. This ruling was later affirmed by the Supreme Court of Delaware.

In another case decided on February 15, 2011, *Air Products & Chemicals, Inc. v. AIRGAS, INC.*, the Court of Chancery upheld the poison pill initiated by the Airgas board, and once again affirmed that “the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors... That is the current state of Delaware law until the Supreme Court changes it.”

In summary, one of the core features of the US substantive takeover rules is the wide discretion enjoyed by the target directors under a court-centred system, relying heavily on general standards by applying the fiduciary duty to determine the defensive actions of the target board against unsolicited bids. This wide discretion granted by the case law in the US has afforded management a largely unrestricted laboratory to innovate various takeover defences.

### 2.3.3 Concluding Remarks

To sum up, the UK takeover regulation pattern features pro-shareholders substantive rules, among which the non-frustration rule is imposed on the target board to prohibit the use of defences without shareholder approval. By contrast, in the US, although the federal government has a neutral stance towards hostile takeovers, statutes and courts at the State level have demonstrated a strong preference towards management. Although subject to judicial scrutiny according to general fiduciary duties, the US management enjoys a wide discretion to implement a considerable body of defensive measures.

### Conclusion

The discussion has made it clear that the UK and the US have developed two diverse regulatory patterns in governing takeover activities. A table comparing the two regulatory patterns in the UK and the US could provide a comprehensive overview of the differences.

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332 Ibid Page 346
333 *Yucaipa American Alliance Fund II, LP v. Riggio*
334 *Air Products & Chemicals, Inc. v. AIRGAS, INC.* A 3d Page 129
jurisdictions regarding their respective takeover regulatory pattern could be presented as follows:

Table 2.2, The Takeover Regulation Patterns in the UK and the US

<table>
<thead>
<tr>
<th>Jurisdictions</th>
<th>Regulation Framework</th>
<th>Regulatory Institutions</th>
<th>Substantive Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>The UK</td>
<td>Rules-based Takeover Code</td>
<td>A Designated Regulatory Authority</td>
<td>Pro-Shareholders</td>
</tr>
</tbody>
</table>

As the first component of the regulatory pattern, the regulation frameworks have presented themselves with diverse defining features in the UK and the US. On the one hand, the regulatory pattern of the UK features a specific rules-based regulation framework based on the comprehensive Takeover Code, as designed and developed by market institutions. On the other hand, the regulatory pattern of the US features a combination of specific rules-based and general standard-based regulation framework. This framework in the US includes: (i) scattered piece of rules, as promulgated by federal legislatures, state legislatures and the federal administrative agent (the SEC), and (ii) general fiduciary duties as interpreted by the State courts.

As the second component of the regulatory pattern, the regulatory institutions have also demonstrated diversity with different status and functions. The predominant takeover regulatory institution in the UK is the Takeover Panel. The Takeover Panel, consists of representatives from main market players, derives from a self-regulatory body and carries full jurisdiction over takeover related matters. Other regulators, such as the judiciary in the UK, have been reluctant to intervene in the takeover regulations. By contrast, in the US, both federal and state legislature have promulgated laws to regulate certain takeover issues. Meanwhile, the federal government, via the SEC, has been active in administering, among others, disclosure rules as prescribed under the federal takeover law. The States courts especially the Delaware Court of Chancery have been providing the main source of case law to substantive matters.

As the third component of the regulatory pattern, again the substantive rules over many takeover matters in the UK and the US have followed almost “diametrically
opposed choices”. The UK has adopted pro-shareholder orientation takeover rules in “putting the target shareholders centre stage” by reserving the power for shareholders when deciding the fate of a takeover bid. The US, by contrast, has developed standards via the Delaware courts’ rulings to confer on a target board broad discretion to defend an unwelcomed offer.

To conclude, the regulatory regimes in the UK and the US have presented two diverse patterns in governing takeover markets. Why do we see such multi regulatory Equilibria in such a key area of corporate regulation? Amongst many theories devoted to explaining the diversity, the theory of path dependence has drawn much attention. It has been argued that takeover regulations as part of corporate law are deeply connected to a country’s historical legacy and its political economy context. Further discussion on the influence of historical legacy and political economy on the takeover regulations will be main focuses of chapter 4-7.

338 Davies and Worthington, Gower and Davies’ Principles of Modern Company Law (9 edn, Sweet & Maxwell 2012) Page 1012
### Appendix 2.1: General Principles of the Takeover Code

<table>
<thead>
<tr>
<th>Principle</th>
<th>Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principle 1</td>
<td>All holders of the securities of an offeree company of the same class must be afforded equivalent treatment; moreover, if a person acquires control of a company, the other holders of securities must be protected.</td>
</tr>
<tr>
<td>Principle 2</td>
<td>The holders of the securities of an offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid; where it advises the holders of securities, the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company’s places of business.</td>
</tr>
<tr>
<td>Principle 3</td>
<td>The board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid.</td>
</tr>
<tr>
<td>Principle 4</td>
<td>False markets must not be created in the securities of the offeree company, of the offeror company or of any other company concerned by the bid in such a way that the rise or fall of the prices of the securities becomes artificial and the normal functioning of the markets is distorted.</td>
</tr>
<tr>
<td>Principle 5</td>
<td>An offeror must announce a bid only after ensuring that he/she can fulfil in full any cash consideration, if such is offered, and after taking all reasonable measures to secure the implementation of any other type of consideration.</td>
</tr>
<tr>
<td>Principle 6</td>
<td>An offeree company must not be hindered in the conduct of its affairs for longer than is reasonable by a bid for its securities.</td>
</tr>
</tbody>
</table>

Source: The UK Takeover Code
### Appendix 2.2: Pill Endorsement and other Constituency/Directors’ Duties Statutes in the US States

<table>
<thead>
<tr>
<th>State</th>
<th>Pill Endorsement Statutes</th>
<th>Other Constituency/Directors’ Duties Statutes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Alaska</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Arizona</td>
<td>0</td>
<td>1 (shall)</td>
</tr>
<tr>
<td>Arkansas</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>California</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Colorado</td>
<td>1</td>
<td>1989</td>
</tr>
<tr>
<td>Connecticut</td>
<td>1</td>
<td>2003 (shall—only specific transactions)</td>
</tr>
<tr>
<td>Delaware</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Florida</td>
<td>1</td>
<td>1989</td>
</tr>
<tr>
<td>Georgia</td>
<td>Explicitly allows dead hand pill</td>
<td>Adopted 1999; Amended 2000</td>
</tr>
<tr>
<td>Idaho</td>
<td>1</td>
<td>1988</td>
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<td>Illinois</td>
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<td>Indiana</td>
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<td>Iowa</td>
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<tr>
<td>Kansas</td>
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<td>Kentucky</td>
<td>1</td>
<td>1989</td>
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<tr>
<td>Louisiana</td>
<td>1</td>
<td>1989</td>
</tr>
<tr>
<td>Maine</td>
<td>1</td>
<td>2003</td>
</tr>
<tr>
<td>Maryland</td>
<td>Explicitly allows dead hand pill</td>
<td>1999</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>1</td>
<td>1989 (shall) No enhanced duties for use of the pill</td>
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<tr>
<td>Michigan</td>
<td>1</td>
<td>2001</td>
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<tr>
<td>Minnesota</td>
<td>0</td>
<td>1997</td>
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<tr>
<td>Mississippi</td>
<td>0</td>
<td>1990</td>
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<td>Missouri</td>
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<td>1989</td>
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<td>Montana</td>
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<td>Nebraska</td>
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<td>W 2007</td>
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<td>Nevada</td>
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<td>1999</td>
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<td>New Hampshire</td>
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<tr>
<td>New Jersey</td>
<td>1</td>
<td>1989</td>
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<tr>
<td>New Mexico</td>
<td>0</td>
<td>1987</td>
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<tr>
<td>New York</td>
<td>W Subject to judicial review</td>
<td>1988, retroactive to 1986</td>
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<tr>
<td>North Carolina</td>
<td>W Subject to judicial review</td>
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<td>North Dakota</td>
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<td>Ohio</td>
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<td>Oklahoma</td>
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<td>Oregon</td>
<td>1</td>
<td>1989</td>
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<tr>
<td>Pennsylvania</td>
<td>1</td>
<td>Adopted 1988; Amendment 1989</td>
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<tr>
<td>Rhode Island</td>
<td>1</td>
<td>1990</td>
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<tr>
<td>South Dakota</td>
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<td>1990</td>
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<tr>
<td>South Carolina</td>
<td>1</td>
<td>2001</td>
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<tr>
<td>Tennessee</td>
<td>1</td>
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<td>2006</td>
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<td>Utah</td>
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<td>Vermont</td>
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<td>Virginia</td>
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<td>1990</td>
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<tr>
<td>Washington</td>
<td>1</td>
<td>1988</td>
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<tr>
<td>West Virginia</td>
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<tr>
<td>Wisconsin</td>
<td>1</td>
<td>1987</td>
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<tr>
<td>Wyoming</td>
<td>0</td>
<td>1990</td>
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</tbody>
</table>

Source: The State of State Antitakeover Law\(^{342}\)

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Chapter 3: Defining the Takeover Regulatory Pattern in China

Introduction

With a growing acknowledgement of the critical role of takeover markets in promoting corporate governance and economic development, it has become crucial for China to establish a legal framework to regulate the takeover market. It is suggested that such a framework should be in line with the conditions of the Chinese takeover market, as well as to ensure consistency with well-developed international norms, in order to ensure an attractive capital market in China for investors.343

This chapter examines the defining features of the Chinese takeover regulatory regime, with a comparison with the features of takeover regimes in the UK and the US, as discussed in the last chapter. The following discussion is structured into three main sections by defining the Chinese features of the three components of a takeover regime, namely, the regulation framework, the regulatory institution, and the substantive rules.

3.1 The Regulation Framework: Specific Rule-based

Administrative Regulation

A priori, a clear understanding of the current Chinese takeover regulation framework requires at least basic familiarity with China’s general legislative framework. Knowledge of this general legislative framework provides a basis for discussion of the status quo takeover regulation framework and its defining features. The section begins with a brief overview of China’s general legislative framework, followed with an examination of the main Chinese takeover regulation framework.

3.1.1 The General Regulation Framework in China

The Chinese legal system does not recognize case law as a formal source of law.344 The current Chinese national regulation framework consists of four main types of

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343 For detailed discussion see the Chapter 7 on the political economy analysis.
344 This, by no means, suggests the courts in China have not been involved with the takeover regulations at all. For further discussion see the infra Section 3.2.2.
regulations: the Constitutional Law, the National Laws, the Administrative Regulations, and the Departmental Rules. Each type of regulation has a different breadth of regulatory content and hierarchical institutions of law making.\(^{345}\)

The highest level within the general regulation framework is the constitutional law. In contrast to the wide application of the supremacy clause or the commerce clause of the US Constitution in judicial review of State anti-takeover statutes, the Chinese Constitution is not relevant to the Chinese takeover regulatory regime. This is not only because the Chinese Constitution mainly prescribes fundamental rules regarding government powers and the political rights of citizens; but, more importantly, the Chinese Constitution has generally been regarded as having non-direct legal application, especially in relation to socio-economic issues.\(^{346}\)

The second level of the regulations is the National Laws. The National Laws are promulgated by the highest national legislative body, namely the National People’s Congress (NPC) or its Standing Committee.\(^{347}\) The National Laws regulate areas such as the financial sector, banking sector, and so on.\(^{348}\) Examples of the National Laws

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\(^{345}\) According to the Law on Legislation of the People’s Republic of China 2015 (The Legislation Law), the congresses or their standing committees of local governments also have authority to produce regulations. These regulations, however, are binding only within the ruling local jurisdictions. Given that the focus of this thesis is regulations applicable nationwide, local rules will not be discussed. See further provisions on jurisdictions of these local rules under the part 4, the Legislation Law 2015. Further discussions over Chinese legislative system could be found on, e.g., Laura Paler, ’China's Legislation Law and the Making of a More Orderly and Representative Legislative System’ [2005] 182 The China Quarterly 301 Li Yahong, ’The Law-making Law: A Solution to the Problems in the Chinese Legislative System?’ (2000) 30 Hong Kong Law Journal 120

\(^{346}\) The enforcement depends on implementing legislation to give meaning its provisions, which provides for judicial application. Moreover, the courts, by general consensus and long-time practice, have been counted out of constitutional interpretation and constitutional rights protections. This will be subject to further discussion in Chapter 5 regard to the Chinese legal origins topics.


\(^{347}\) Article 62, Constitution

\(^{348}\) Article 8 of the Legislation Law, the following affairs shall only be governed by national laws:

1. matters concerning State sovereignty; formation, organization, and the functions and powers of the people’s congresses, the people’s courts and the people’s procuratorates at different levels;
2. the system of regional national autonomy, the system of special administrative region and the system of self-government among people at the grassroots level; crimes and criminal punishment;
3. deprivation of political rights of citizens and coercive measures and punishment involving restriction of personal freedom;
4. requisition of non-State-owned Shares; basic civil system;
5. basic economic system and basic systems of finance, taxation, customs, banking and foreign trade;
relevant to takeover transactions include, *inter alia*, the Companies Act 2006, and the Securities Act 2006.\textsuperscript{349}

Below the level of the National Laws are the Administrative Regulations as produced by the State Council.\textsuperscript{350} These Administrative Regulations are to implement the National Laws, and must be consistent with the National Laws and the Constitutional Law.\textsuperscript{351} The most relevant Administrative Regulations impinging on takeovers are the Interim Provisions on the Management of the Issuing and Trading of Stocks, issued in 1993.

The lowest level in the current Chinese legislation framework is Departmental Rules. Departmental Rules are produced by departments of the State Council and applicable to the field administered by respective departments.\textsuperscript{352} The departments responsible for regulating takeovers include the China Securities Regulatory Commission (CSRC) whose responsibilities include overseeing the securities market;\textsuperscript{353} the Ministry of Commerce (MOFCOM) whose responsibilities include overseeing inbound foreign investment;\textsuperscript{354} the State-owned Assets Supervision and Administration Commission (SASAC) whose responsibilities include overseeing State assets management;\textsuperscript{355} and

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\textsuperscript{349} For example, the Anti-Monopoly Act 2008 and its implementing rules may step in as long as a takeover transaction triggers a merger control issue.

\textsuperscript{350} For example, the Anti-Monopoly Act 2008 and its implementing rules may step in as long as a takeover transaction triggers a merger control issue.

\textsuperscript{351} According to Article 4 of the Regulations on Procedures for the Formulation of Administrative Regulations as promulgated by the State Council in November 2001, administrative regulations shall be named “regulations”, “provisions” or “measures”.

\textsuperscript{352} Article 90, Constitution

\textsuperscript{353} Authorized by the State Council, in accordance with relevant laws and regulations, the China Securities Regulatory Commission, a ministry-level unit directly under the State Council, regulates China’s securities and futures markets with an aim to ensure their orderly and legitimate operation. See the office website: \url{http://www.theCSRc.gov.cn/pub/theCSRc_en/}.

\textsuperscript{354} The Ministry of Commerce of the People’s Republic of China, formerly Ministry of Foreign Trade and Economic Co-operation (MOFTEC) is an executive agency of the State Council of China. It is responsible for formulating policy on foreign trade, export and import regulations, foreign direct investments, consumer protection, market competition and negotiating bilateral and multilateral trade agreements. See the office website: \url{http://english.mofcom.gov.cn/mission.shtml}.

\textsuperscript{355} It is responsible for managing China’s state-owned enterprises, including appointing top executives and approving any mergers or sales of stock or assets, as well as drafting laws related to state-owned enterprises. See the office website: \url{http://www.sasac.gov.cn/n2963340/n2963393/2965120.html}. 


the State Administration for Industry & Commerce (SAIC) whose responsibilities include overseeing enterprise registration.356

Among other departments, the CSRC has been the predominant institution in producing and enforcing takeover rules.357 The most vital Departmental Rules in relation to takeovers have been issued by the CSRC, namely, the Administrative Measures for the Takeover of Listed Companies (The Takeover Measures), first issued in 2002 and recently amended in 2014. The Takeover Measures is dedicated to providing comprehensive rules to regulate takeover market.358

Meanwhile, the CSRC, in conjunction with other departments, has produced many other Departmental Rules to regulate various aspects of takeover transactions. They include, to name a few, the Provisions on Acquisitions of Domestic Enterprises by Foreign Investors 2006,359 which apply to takeover activities initiated by foreign companies; and the Interim Administrative Measures for the Transfer of State-owned Shares of Listed Companies 2005),360 which apply to the supervision and administration of takeover activities involving State-owned property.361

As presented in the following Table 3.1, the bulk of regulations pertaining to the takeovers have mainly originated from the executive branch, either the State Council (the third level) or Departments (the fourth level). There are limited sources of takeover rules promulgated by the legislative branch (the second level). Plus the fact that the Stare Decisis principle is not acknowledged under the Chinese legal system, the takeover regulation framework in China has manifested a feature of administrative regulation dominancy.

Table 3.1, Main Sources of Takeover Regulations in China

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356 It is stated that the State Administration for Industry & Commerce (SAIC) of the People’s Republic of China is the competent authority of ministerial level directly under the State Council in charge of market supervision/regulation and related law enforcement through administrative means. See the office website: http://www.saic.gov.cn/english/aboutus/Mission/.

357 See further discussion in the infra Section 3.2.1

358 Further discussion on the Takeover Measures is under the infra section 3.1.3

359 The Provisions are jointly promulgated by the CSRC, the MOFCOM, the SASAC, the SAIC, the State Administration of Taxation (SAT) and the State Administration of Foreign Exchange (SAFE).

360 The Interim Administrative Measures are jointly promulgated by the CSRC and the SASAC.

361 Many other regulations on the supervision and administration of State-owned property also play a critical role in the takeover regime, given that many listed companies are controlled directly or indirectly by the state. Detailed discussion over the ownership market could be found in Chapter 7.
<table>
<thead>
<tr>
<th>Legislation Levels</th>
<th>Legislation Titles</th>
<th>Legislative Institutions</th>
<th>Jurisdiction</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Law</td>
<td>Securities Act 2014</td>
<td>The National People’s Congress</td>
<td>General Corporate/Securities Market</td>
</tr>
<tr>
<td></td>
<td>Companies Act 2014</td>
<td></td>
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<tr>
<td></td>
<td>Anti-Monopoly Act 2008</td>
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<td></td>
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<tr>
<td>Departmental Rule</td>
<td>Administrative Measures for the Takeover of Listed Companies 2014</td>
<td>The CSRC</td>
<td>General Takeover Market</td>
</tr>
<tr>
<td></td>
<td>Provisions on Acquisitions of Domestic Enterprises by Foreign Investors 2009</td>
<td>The CSRC, The MOFCOM, The SASAC, The SAIC, The SAT</td>
<td>Special Regulations on Takeovers of State-owned Shares</td>
</tr>
<tr>
<td></td>
<td>Circular on Issues Related to Transferring State Shares or Legal Person Shares of Listed Companies to Foreign Investors 2002</td>
<td>The CSRC, The PBC, The SAFE</td>
<td>Special Regulations on Takeovers of State-owned Shares</td>
</tr>
<tr>
<td></td>
<td>Interim Administrative Measures for the Transfer of State-owned Shares of Listed Companies 2007</td>
<td>The CSRC, The MOF, The SETC</td>
<td></td>
</tr>
</tbody>
</table>
This administrative regulations-dominant takeover regulation framework in China differentiates itself from that framework in the UK, where the Takeover Code, essentially a self-regulation with statutory footing, dictates the takeover regulations. The Chinese takeover regulation framework also differs from the US framework, which features the State case law system supplemented by the Federal-State statutory law.  

**3.1.2 Takeover Rules under the General Corporate/Securities Laws**

The following section will examine the takeover rules under the general corporate/securities laws, which lay down the foundation framework for the comprehensive takeover rules as prescribed under the Takeover Measures. (Discussed in the Section 3.1.3)

**3.1.2.1 Takeover Rules under Interim Provisions on the Management of the Issuing and Trading of Stocks**

The first influential regulation elaborating upon takeover rules is the Interim Provisions on the Management of the Issuing and Trading of Stocks (The IPMITS), issued by the State Council in 1993. The IPMITS is the first basic administrative regulation on the issuing and trading of stocks, and other related securities activities within Chinese territory. It covers a broad number of areas, such as the conditions and the procedure for stock issuance, the content of and approach to information disclosure, mergers and acquisitions, etc.

Regarding the regulation of takeovers, the IPMITS prescribes detailed rules in Chapter 4, from Article 46 through Article 52. These provisions specify how a company can purchase the publicly traded stocks of another company. The IPMITS establishes the basic procedure for taking over a listed company in China. Two key areas regulated by the IPMITS are information disclosure rules and the mandatory bid requirement.

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362 The supra Section 2.1, Chapter 2  
363 It has eight chapters, which are Chapter 1, General Provisions; Chapter 2, Issuance of Stocks; Chapter 3, Trading of Stocks, Chapter 4, Takeover of Listed Companies; Chapter 5, Safekeeping, Clearance and Transfer, Chapter 6, Information disclosure by Listed Companies; Chapter 7, Investigation and Punishment; Chapter 8, Arbitration of Disputes; Chapter 9, Supplementary Provisions.  
364 Excluding the Hong Kong Special Administrative Region and the Macao Special Administrative Region  
365 Article 2, the IPMITS
As mentioned earlier, to protect target corporations from corporate raiders, both the UK and the US takeover laws require adequate transparency through disclosure rules so that shareholders can make informed decisions. The IPMITS also stipulate a broad transparency requirement once one investor holds a certain amount of the outstanding shares of a listed company.

The IPMITS provide that a shareholder who has acquired 5% of a listed company’s share is required to disclose his stock holding positions within three business days of acquiring those positions. Thereafter, that shareholder is required to disclose his position within three business days after every 2% change in ownership. Meanwhile, the shareholder is prohibited from trading more shares during the period prior to the date on which he disclosed his position and another two working days thereafter; so that the market has an opportunity to gain awareness of his ownership position.

This rule is very similar to requirements in the US and the UK. For example, Section 13(d) of the US Securities Exchange Act imposes a disclosure requirement on persons within ten days of the date that they acquire beneficial ownership of more than 5% of a public company. The same section also prohibits substantial shareholders from continuing to purchase shares during this period before making the announcement.

The compliance with, and enforcement of, the disclosure rules under the IPMITS were tested in the first ever hostile takeover battle to occur in China. In September 1993, with a strong belief that the target firm would realize its considerable potential for further development after significant restructuring, the Shenzhen-listed China Bao’an Group Co. Ltd. (Bao’an) launched an unfriendly attempt to take over Shanghai Yanzhong Industrial Co. Ltd. (Yanzhong). This was achieved by way of a purchase of Yanzhong’s stocks on the secondary market. Bao’an, however, only made the announcement to the public and the report to the regulatory authority, namely the CSRC, after it controlled 16% of the outstanding shares of Yanzhong.

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366 For UK, it is provided, inter alia, under Rule 8 Disclosure of Dealings and Positions with the takeover Code; while US, the William Act.
367 Article 47, the IPMITS
368 Article 47, the IPMITS
369 13d, Securities Exchange Act
These shares were bought by three subsidiaries of Bao’an, none of whom had separately crossed the 5% threshold before the final purchase.

To retain its controlling stake, the board of Yanzhong hired Schroeder Investment Management (Hong Kong) as an advisor for its anti-takeover strategies. One of the strategies was to sue Bao’an in breach of disclosure duties as set out under Article 47 of IPMITS. Yanzhong at the same time reported the incident to the CSRC.

In contrast to the court’s reluctance to intervene, the CSRC promptly announced its binding rulings in October, by declaring that the secret acquisition and the late report filing had breached the disclosure rules and, as a consequence, imposed RMB 1 million on Bao’an. Nevertheless, the share transaction remained valid. Bao’an Group hence gained control of Yanzhong. The manner in which this dispute was resolved indicated the starting features of the takeover law enforcement in China: a mechanism led by an administrative authority instead of the judicial system or a self-regulatory entity.

The other main concern of the takeover provisions under the IPMITS is the mandatory bid requirement. The IPMITS prescribes that once a shareholder, other than promoters, obtains, directly or indirectly, 30% or more of the common shares issued by a listed company, this shareholder is obliged to issue an offer to purchase, in cash, the remaining shares of the company within 45 days. The IPMITS provisions also stipulate that the price of this mandatory offer must be the higher of either (i) the highest price paid for the shares by any buyout within 12 months before the present buyout offer is made; or (ii) the average market price of such shares within the 30 days before the offer is made.

371 Specifically, the CSRC determined that Bao’An violated the IPMITS in two ways: (1) it failed to publicly disclose its ownership within the required period of time when it became a 5% shareholder of Yanzhong through stock purchases by its two affiliates and (2) it continued to purchase shares of Yanzhong when it was required to cease such activity immediately prior to publicly disclosing its ownership position in Yanzhong. Cited from Chun, ‘Brief Comparison of the Chinese and United States Securities Regulations Governing Corporate Takeovers’ (1998) 12 Columbia Journal of Asian Law 99

372 Other rulings included: (a) the short swing profits derived from selling 264,000 shares back to the public on September 30 by Bao’an were to be transferred to Yanzhong; and (b) Bao’an was not be allowed to purchase any more Yanzhong shares until November 4. See Wendong Shi, Study on the Enterprise Growth under the Transformation Economy Environment: Taking China’s First Joint-Stock Enterprise as an Example (Diplomica-Verl. 2009); also Peng, Business Strategies in Transition Economies (Sage Publications 2000)

373 Article 48, the IPMITS.
The mandatory bid rule provided under the IPMITS is almost identical to the Rule 9 of the UK Takeover Code. Article 5 under the EU Takeover Directive elaborates a similar rule on mandatory bids, although it is made optional. In contrast, neither Delaware case law nor the federal Williams Act requires a 30% shareholder to make a general offer. The mandatory bid rule is generally considered to be capable of providing a great degree of equal treatment amongst all target shareholders, since the control premium is shared amongst all shareholders. Therefore, the Chinese IPMITS and the UK Takeover Code may appear more attractive than their US counterpart from this point of view.

Pursuant to the IPMITS, a coercive tender towards target shareholders is neither permitted. A takeover offer must be open for at least 30 working days from the date of issue. During this period of time the shareholders who accept the tender earlier have a right to withdraw their acceptance later. In addition, if the amount of shares purchased by the offeror has reached 90% of the total shares upon closure of the offering period, the remaining shareholders have the right to sell out their shares to the bidder under a similar condition. This rule is very similar to the right of sell-out stipulated under Article 16 of the EU Takeover Directive.

Briefly, the IPMITS was the first attempt to regulate the trading of securities on the Chinese stock market. Encompassing as it did the basic rules to regulate stock issuance and exchange, the IPMITS was undoubtedly of critical importance at the

374 Rule 9; Section F. The Mandatory Offer and Its Terms; The Takeover Code
378 Article 49, the IPMITS
379 Article 52, the IPMITS
380 Article 51, the IPMITS
381 Article 16, The right of sell-out, Takeover Directive:
Member States shall ensure that, following a bid made to all the holders of the offeree company’s securities for all of their securities, paragraphs 2 and 3 apply. Member States shall ensure that a holder of remaining securities is able to require the offeror to buy his securities from him at a fair price under the same circumstances as provided for in Article 15(2).
382 For the evolution of securities market in China in detail, please see the chapter 7 on the political economy analysis.
time of its introduction.\footnote{Chen, Daisong. 2009. Legal Development in China’s Securities Market during Three Decades of Reform and Opening-up. \textit{Working Paper Series No. 005}, Asian Law Institute.} Due to the policy makers’ limited knowledge about the securities market and the persistent ideological vigilance towards capitalism in that period, however, the IPMITS represented a conservative attitude towards the market for takeovers.

One of the obvious examples of this conservatism is that only a registered corporation as a legal person may be allowed to acquire a significant amount, here 0.5\%, of the outstanding shares of a listed company.\footnote{An individual citizen can only hold no more than 0.5\% of the outstanding shares. If an individual citizen’s equity interest exceeds the threshold, then the company must acquire the excess shares with the CSRC’s approval at a price that is the lower of the market price or the individual’s original purchase price. However, if the exceeded part is due to the later reduction of the total shares issued, it is allowed to be held within a reasonable period of time without having to be purchased. Article 46, the IPMITS} With the development of the securities market and takeover transactions, the IPMITS appeared to be incapable of meeting the need for flexible takeover regulations.\footnote{Huang, ‘China’s Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 Delaware Journal of Corporate Law 145; Hui Huang, \textit{China’s Takeover Law: Regulation and Reform} (Vandeplas Publisher 2006)} Consequently, a further enabling takeover regime was established with the advent of the Companies Act and Securities Act, which supplement or replace some strict rules set under the IPMITS.\footnote{For examples, the rule that no individual may hold 0.5 per cent or more of the outstanding common shares of a listed company has been abrogated; and the considerations have been expanded to cash and/or shares from the cash as the only consideration under Securities Act 2006. Further discussion and other examples will be given in the following parts.}

\section*{3.1.2.2 Takeover Rules under Companies Act}


The official use of the term “socialist market economy” appears in the Decision of the Central Committee of the Communist Party of China on Some Issues Concerning the Improvement of the Socialist Market Economy adopted in 1993. According to this Decision, the “socialist market economy” refers to a market-oriented economy where the state-owned enterprises function as the dominant market players. Further discussions are followed in}
The Companies Act prescribes a structural framework of general application to corporate governance and corporate activities within China. Many provisions of the Companies Act are also applicable to takeovers. Of particular importance to the discussion of takeover rules, Chapter 9 under the title of *Merger, Division, Increase and Deduction of Registered Capital* regulates takeover transactions from Article 173 through Article 175. In addition, Chapter 4 (relating to joint stock limited companies), Chapter 5 (relating to the issuance and assignment of shares of joint stock limited companies), and Chapter 10 (relating to dissolution and liquidation) are also relevant with respect to takeovers of listed companies.

The Companies Act clarifies some fundamental legal definitions relating to the takeovers of listed companies. A takeover is defined as a transaction whereupon one company absorbs another company; the absorbed company is dissolved and ceases to exist after the transaction. Some other important terms relevant to takeover transactions such as, *inter alia*, controlling shareholders, *de facto* controller, connection relationship, etc., are also defined in Article 217.

The Companies Act adheres to the shareholder primacy principle under which the fundamental corporate affairs are predicated upon the shareholders’ approval. For example, it is for the shareholders to decide on the operational policy and investment

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389 The Companies Act incorporates a total number of thirteen chapters, which are Chapter I General Provisions, Chapter II Incorporation and Organizational Structure of a Company with Limited Liability, Chapter III Equity Transfer of Companies with Limited Liability, Chapter IV Incorporation and Organizational Structure of a Company Limited by Shares, Chapter V Issue and Transfer of Shares of Companies Limited by Shares, Chapter VI Qualifications and Obligations of Directors, Supervisors and Senior Managers of Companies, Chapter VII Corporate Bonds, Chapter VIII Financial Affairs and Accounting of Companies, Chapter IX Merger and Division of Companies, Increase and Reduction of Capital, Chapter X Dissolution and Liquidation of Companies, Chapter XI Branches of Foreign Companies, Chapter XII Legal Responsibility, Chapter XIII Supplementary Provisions

390 Article 173, the Companies Act

391 A controlling shareholder means a shareholder whose capital contribution accounts for more than 50 per cent of the total capital of a company with limited liability or the amount of the shares who holds accounts for more than 50 per cent of the total amount of the shares of a company limited by shares; and a shareholder, although the amount of his capital contribution or the proportion of the shares he holds is less than 50 per cent, whose voting rights enjoyed on the basis of the amount of capital contribution made or the number of shares held are enough to have a vital bearing on the resolutions of a shareholders assembly or a shareholders general assembly. Paragraph 2, Article 217, the Companies Act

392 A *de facto* controller means a person who is able practically to govern the behaviour of a company through investment relations, agreements or other arrangements, although the person is not a shareholder of the company. Paragraph 3, Article 217, the Companies Act

393 Connection relations refer to relations between the controlling shareholder, *de facto* controller, director, supervisor and senior manager of a company with the enterprises which are directly or indirectly under their control, and other relations which may lead to transfer of the company’s interests. Connection relations do not exist among the holding companies of the State although their shares are held by the State in common.
plan of the company, to elect directors and determine their remuneration, to amend the articles of association of the company; and so on.\textsuperscript{394} Substantial decisions relevant to a takeover transaction such as the adoption of a resolution on an amendment to the articles of association, or other takeover related-matters are even subject to super majority support at the shareholders’ meeting.\textsuperscript{395}

The fiduciary duty rules play vital roles in assessing directors’ decisions in the context of takeovers.\textsuperscript{396} The Chinese Companies Act also clarifies and strengthened the compliance of the fiduciary duty in 2006 by the introduction of a whole new Chapter 6 entitled The Duties of Directors and Senior Managers.\textsuperscript{397} The Article 148 stipulates that directors and senior managers are subject to duties of loyalty, care and diligence. Article 147 sets out the grounds on which a person may be disqualified from being a director, while Article 149 provides a list of behaviours that directors and senior managers are prohibited to engage in. For example, a director is not permitted to issue company capital as loans to any person without an approval at the shareholders’ meeting.\textsuperscript{398} In instances of breaches of any of these fiduciary duties, a derivative action may be brought against the wrongdoing directors or senior managers.\textsuperscript{399}

\begin{itemize}
  \item Article 38 of Companies Act lists the exclusive power enjoyed by the shareholder meeting:
    \begin{itemize}
      \item to decide on the operational policy and investment plan of the company;
      \item to elect or replace directors and supervisors who are not representatives of the staff and workers, and to decide on matters concerning the remuneration of the directors and supervisors;
      \item to examine and approve reports of the board of directors;
      \item to examine and approve reports of the board of supervisors or the supervisors;
      \item to examine and approve the annual financial budget plan and final accounts plan of the company;
      \item to examine and approve the company’s plans for profit distribution and for making up losses;
      \item to adopt resolutions on the increase or reduction of the registered capital of the company;
      \item to adopt resolutions on the merger, division, dissolution, liquidation or transformation of the company;
      \item to amend the articles of association of the company; and
      \item other functions and powers provided for in the company’s articles of association.
    \end{itemize}
  \item \textsuperscript{395} “…A resolution to be made by the shareholders general assembly shall be subject to adoption by more than half of the voting rights held by the shareholders present at the meeting. But resolutions to be made by the shareholders general assembly on revision of the company’s articles of association, on increase or reduction of the registered capital, on merger, division, dissolution or transformation of the company shall be subject to adoption by more than two-thirds of the voting rights held by the shareholders present at the meeting.” Article 104, the Companies Act.
  \item Article 16, the Companies Act.
\end{itemize}

A director might selectively provide the company capital as loans to a favourite takeover bidder hence causing unfairness to other bidders. The similar prohibition could be found under the non-frustration rule within the Takeover Measures.

\textsuperscript{399} Article 150, 152, 153, the Companies Act
3.1.2.3 Takeover Rules under Securities Act

The current Securities Act was originally adopted in 1998, and revised thereafter in 2004, 2005, 2013 and 2014. The Securities Act regulates the issuance and transacting of stocks, corporate bonds and other securities recognized by the State Council. It is set to protect the interests of investors; to ensure a fair or a level playing field between state, private, and foreign shareholders; and to encourage an efficient capital market. The Securities Act has also paid considerable attention to takeover regulations by the dedicated Chapter 4 *The Takeovers of Listed Companies* that incorporates 17 articles from Article 85 through Article 101.

The Securities Act signals a policy attitude towards encouraging a vibrant takeover market, which is expected by the policy makers to be able to improve the corporate governance of SOEs and to maintain robust economic progress. For example, the Securities Act removes the restriction as set under the Article 46 of the IPMITS on a natural person holding more than 0.5% of a company’s outstanding shares. In addition, the Securities Act attempts to reduce transaction costs by stipulating that after an investor has publicly announced an acquisition of 5% of a targeted company, this investor is only required to disclose his/her shareholding if there is another change of 5% of the outstanding shares; rather than 2% as previously required under the Article 60 of the IPMITS.

Although the mandatory bid rule could offer a great degree of shareholder protection by ensuring that the control premium is shared amongst all shareholders, this rule comes at the expense of the contestability of takeovers. Put differently, the increasing costs of takeovers could frighten off potential bidders and then deter a vibrant

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400 For the discussion on the development of the Securities Act, see Chapter 7.
402 Article 2, the Securities Act
403 For further political economy explanations, see Chapter 4 of this thesis.
404 See previous section on the Interim Provisions on the Management of the Issuing and Trading of Stocks
405 Article 85, the Securities Act
takeover market. 406 This concern is also reflected in the current Securities Act. According to the Securities Act, an investor having acquired 30% of a company’s shares may apply to the State Council’s securities regulatory authority, i.e., the CSRC, for an exemption from the mandatory bid requirement as originally set by IPMITS. 407 However, if that exemption is not granted, the shareholder is required to make a mandatory bid to all of the shareholders for their shares, either through the use of stock or cash as the consideration. 408

3.1.3 The Takeover Measures

In order to enhance regulatory efficacy, the Securities Act designates legislative power to the CSRC to formulate “necessary rules, regulations, guidance, or standards relevant to the functions of the securities market”. 409 Accordingly, the CSRC in 2002 issued the Administrative Measures for the Takeover of Listed Companies (Takeover Measures), which was substantially amended in 2006, followed by another three minor revisions thereafter. 410 The revised 2006 Takeover Measures compiled and replaced various scattered regulations published before. 411 The Takeover Measures and the amendments have significantly expanded the takeover rules to cover matters in relation to the regulation over takeovers of listed companies and other related share transfer activities in China.

The Takeover Measures prescribe rules over information disclosure requirement, tender offer takeovers, takeovers by agreements, indirect takeovers, duties of financial advisors, post-transaction supervision, enforcement and legal liabilities. The Takeover Measures are set to “suit the new environment whereby the national economy is going

407 The Securities Act does not provide further rules on the circumstances under which a bidder may apply for an exemption. This is only provided under the Article 62, 63 of the Takeover Measures.
408 Article 96, the Securities Act
409 Article 101, the Securities Act
410 Among the three revisions, the first two are on the mandatory bid rule, the exceptional circumstances to waive the full mandatory bid obligation and the applicable procedure as prescribed under the article 62&63. The third revision was carried out in 2014. Among others, the new revision in 2014 expands the exceptional circumstances to waive the full mandatory bid obligation, abolishes the offeror’s duties to submit the tender offer report to the CSRC and its local offices, and clarifies penalties for wrongdoing offerors and financial advisors.
through the strategic restructuring process and the shareholding structure of listed companies is undergoing a radical transformation."\footnote{Lusong Zhang, Regulation of Foreign Mergers and Acquisitions Involving Listed Companies in the People’s Republic of China (Kluwer Law International 2007); Huang, ‘The New Takeover Regulation in China: Evolution and Enhancement’ (2008) 42 International Lawyer 153.}

The underlying policy purpose of the Takeover Measures is to prevent opportunistic takeovers of companies listed in China, while at the same time encouraging bona fide takeovers.\footnote{Huang, ‘The New Takeover Regulation in China: Evolution and Enhancement’ (2008) 42 International Lawyer 153.} For example, it sets out detailed criteria banning certain investors from taking over listed companies. An acquirer, under any of the following circumstances, is not permitted to take over the control of a listed company:\footnote{Article 6, the Takeover Measures}

1) The acquirer fails to repay the huge liabilities at maturity;
2) The acquirer has been accused of serious law breaking in the last 3 years;
3) The acquirer has engaged in serious discredited behaviours in the securities market in the last 3 years;
4) A natural person acquirer is subject to Article 147 under the Companies Act;\footnote{None of the following persons shall serve as a director, supervisor, or senior manager of a company:}
   1) a person who has no or limited capacity for civil conduct;
   2) a person who was sentenced to criminal punishment for embezzlement, bribery, seizure of property or misappropriation of property or for sabotage of the socialist market economic order, where less than five years have elapsed after the expiration of the period of execution; or a person who was deprived of his political rights for the commission of a crime, where less than five years have elapsed after the expiration of the period of execution;
   3) a person who, being a director or the head or manager of a company or enterprise that went into bankruptcy and liquidation, was personally liable for the bankruptcy of the said company or enterprise, where less than three years have elapsed from the date liquidation of the company or enterprise is completed;
   4) a person who, being the legal representative of a company or an enterprise, the business license of which was revoked for violation of law and which was ordered to close down, was personally liable for the above, where less than three years have elapsed from the date the business license of the company or enterprise is revoked;
   5) a person who fails to liquidate a relatively large amount of personal debts when they are due.\footnote{Article 147, the Companies Act}
Where a company elects or appoints its directors or supervisors, or engages its senior managers in violation of the Provisions of the preceding paragraph, such election, appointment or engagement shall be invalid.
Where, during his term of office, a director, supervisor or senior manager is found to be a person as specified in the first paragraph of this Article, the company shall remove him from office.

Article 147, the Companies Act

\footnote{Huang, ‘The New Takeover Regulation in China: Evolution and Enhancement’ (2008) 42 International Lawyer 153.} Moreover, the Takeover Measures for the very first time introduce regulation of Management Buy-Outs (MBOs).\footnote{Article 51, the Takeover Measures} It defines a MBO as a takeover of a listed company by directors, supervisors, senior managers, employees of a listed company; or by any other organization under the control of, or entrusted with, the listed company.\footnote{Article 51, the Takeover Measures} Compared to ordinary takeovers, the Takeover Measures impose much
more stringent regulation on MBOs.\footnote{For example, the resolution on MBO shall be made by disinterested directors, be consented by more than two thirds or more of independent directors, be submitted to the general meeting of shareholders of the company for deliberation and be adopted by more than half or more of the voting rights held by disinterested shareholders who attend at the general meeting of shareholders. Article 51, the Takeover Measures} MBOs have long raised serious political, as well as ethical issues, mainly due to the fact that the vast majority of Chinese listed companies are actually reorganized SOEs.\footnote{For example, the under-valued share price has been very common due to a lack of sufficient supervision. See further at On Kit Tam, ‘Ethical Issues in the Evolution of Corporate Governance in China’ (2002) 37 Journal of Business Ethics 303}

Despite these restrictions on bidders, the Measures release acquirers from many other limitations imposed by the previous law and regulation. For instance, pursuant to the Securities Act 2014 a bidder may purchase a listed company by means of a public offering or a special purchase agreement, as well as by other legal means, such as the indirect purchase of a listed company.\footnote{Article 85, the Securities Act} The Securities Act, however, has not provided detailed clarification in relation to the indirect purchase of a listed company. Regarding this, the Takeover Measures set out the Chapter 5 \textit{Indirect Takeover} to elaborate detailed provisions about indirect purchase as a official means to takeover listed companies. In addition, the Takeover Measures stipulate the centralized trading on a stock exchange at competing prices as an alternative mechanism for takeovers of listed companies.\footnote{Article 61, the Securities Act}

The methods of payment have also been expanded. Previously, an offer could be made only in cash consideration. Under the current Takeover Measures, however, a bidder could use cash, securities, combination of cash and securities, or any other lawful method to purchase a listed company’s shares.\footnote{But in the case of a full bid, the acquirer must provide cash as an alternative for the target shareholders to choose. Article 27, 36, 54, 55, the Takeover Measures.} This renders the takeover in China more consistent with international practices where a combination of cash and shares are commonly offered as consideration in takeover bids.\footnote{Richard Dobbs, Marc Goedhart and Hannu Suonio, ‘Are companies getting better at M&A? The Latest Boom in Merger Activity Appears to be Creating More Value for the Shareholders of the Acquiring Companies’ (2006) McKinsey Quarterly 2}

The Takeover Measures also strive to protect the interests of minority shareholders. The transparency principle of takeover transactions is reaffirmed. Information disclosures made by relevant parties are required to be truthful, accurate, and complete; detailed procedures and specifications of how to make timely reports and
announcements are specified.\footnote{See Chapter 2, the Takeover Measures} Meanwhile, it extends the fiduciary duty from the directors, supervisors and senior managements to shareholders who actually control listed companies.\footnote{Article 8, 9, the Takeover Measures} The prohibition against anti-takeover measures initiated by a target’s management is another proof of the protection of shareholders, especially minority shareholders. Anti-takeover measures and their regulations will be further elaborated under the infra Section 3.3.

There are also significant changes to the previous mandatory bid rule. With the objective of reducing transactions costs associated with takeovers and affording greater flexibility to potential acquirers,\footnote{Huang, ‘The New Takeover Regulation in China: Evolution and Enhancement’ (2008) 42 International Lawyer 153} the current Takeover Measures allow a bidder to choose either to make a general offer, i.e., an offer made to all of the shareholders of the company for all of their outstanding shares; or a partial offer, i.e. an offer made to all of the shareholders but only for part of their shares, subject to a minimum requirement of 5% of the company’s shares in issue.\footnote{Article 88, the Securities Act}

This partial tender offer rule, in addition to the existing exemptible circumstances as provided under the Securities Act, further weakens the effect of the general mandatory bid requirement. As shown by the figure 3.1, the CSRC has exempted the mandatory bid rules to most of the takeover cases. This policy choice again reflects Chinese policy makers’ preference to facilitate takeovers by mitigating the destructive effect of the general mandatory bid rule and making it easier for a bidder to acquire control over a listed company.\footnote{Cai, ‘The Mandatory Bid Rule in China’ (2011) 12 European Business Organization Law Review 653; Huang, ‘China’s Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 Delaware Journal of Corporate Law 145}

Figure 3.1, Exemptions to the Mandatory Bid Rule
Another important new feature of the Takeover Measures is their imposition of the prominent role of “financial consultants” in takeover transactions. The Takeover Measures delegate many responsibilities to financial consultants to examine, track and supervise the acquirer’s behaviour, prior, during and following acquiring transactions of listed companies. It has become a mandatory obligation for all acquirers to hire financial consultants to conduct due diligence and perform some monitoring roles before and after transactions, on foot of the 2006 revision on the Takeover Measures.

3.1.4 Concluding Remarks

In brief, the Securities Act, together with other regulations such as the IPMITS and the Companies Act, has established a “relatively mature regulatory regime” for the securities market. Nevertheless, these regulations have formed only a sketched framework which appears to be incapable of meeting the need for sufficient regulation of takeover transactions. Therefore, it demands a comprehensive system to fully regulate takeovers. In this respect, the CSRC, as the most visible regulator of

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430 Chapter VII, Financial Consultant, the Takeover Measures
431 Article 65-68, the Takeover Measures
432 Article 9, the Takeover Measures;
At the same time, financial consultants also need to pay attention to any possible misconduct by foreign acquirers to the listed companies in question and to monitor activities of the listed companies after the transactions. Article 69 & 71, the Takeover Measures.
the stock market, has issued many takeover rules, independently or together with other departments. Amongst others, the Administrative Measures for the Takeover of Listed Companies (The Takeover Measures) constitute the most comprehensive law in relation to takeovers of listed companies in China.

3.2 The Regulatory Institution: An Administrative Agent for the General Securities Market

The takeover regulatory institutions are authorities empowered by a regulation framework to administer and enforce substantive rules as prescribed within the regulation framework. As discussed in the past Chapter 2, they have manifested different organic nature and enforcing mechanisms in the UK and the US. In the UK the takeover regulatory institution is a centralized authority essentially an autonomous private agent. In contrast, the federal system in the US creates a dual level regulatory structure where the general federal securities market regulator and the State Courts administer different aspects of takeover regulations.

In China, Pursuant to the Securities Act, the power to administer and enforce takeover rules is bestowed on a general securities market regulator within the State Council, namely, the CSRC.\textsuperscript{435} The following section will examine the regulatory functions and mechanisms as undertaken by the CSRC. The roles of Chinese courts in the takeover regulations will be also analysed as a comparative reference to the UK and the US.

3.2.1 The Predominant Roles the CSRC

The CSRC is charged with implementing centralized and unified regulation of China’s securities market. Its roles are to carry out supervision and administration of the securities market according to law so as to preserve the order of the securities market and guarantee the legitimate operation thereof.\textsuperscript{436} With respect to takeover law matters, it undertakes a virtually exclusive dispute resolution role.\textsuperscript{437}

\textsuperscript{435} Article 7, the Securities Act.
\textsuperscript{436} Article 178, the Securities Act.
3.2.1.1 The Nature and Functions of the CSRC

The CSRC is established in October 1992 as a ministry-level government agency under the direction of the State Council.\(^{438}\) The CSRC comprises 21 functional departments and 4 specialized units. It also has 38 regional offices across the country and 19 affiliated institutions under its supervision. The CSRC’s headquarters, regional offices and affiliated institutions work together to form the national regulatory system of the securities and futures markets. (The Appendix 3.1, the CSRC Organizational Chart)

The CSRC as the administrative regulator has been enjoying and expanding its prevailing authority to regulate the securities market, including the takeover market.\(^{439}\) For example, the Securities Act in 1998 mandate the filling of an ex-ante takeover statement by the bidder at least 15 days before the intended public announcement, but it did not afford the CSRC any authority to substantially review the statement.\(^{440}\) However, in 2002 the CSRC empowered itself with the substantial authority to review, and then approve or reject the submitted statement. A bidder may only announce its offer if the CSRC has not raised any objection to the statement within the 15-day processing period.\(^{441}\) Following the 2006 revision, the Securities Act re-affirms this approval power. It provides that if the submitted statement fails to satisfy the provisions of the relevant laws and administrative regulations, the reporter must not announce the takeover offer.\(^{442}\)

Furthermore, the Securities Act, after the 2006 amendment, bestows the regulator with more powers to perform its regulatory duties. Article 179 and Article 180 of the new Securities Act confer upon the CSRC a wide range of investigation and information-gathering powers to carry out supervision and administration of the

\(^{438}\) The inception and the evolution of the CSRC is further discussed in the *infra* Chapter 7.

\(^{439}\) The CSRC make “make supervision and administration over the takeover of listed companies and the related alteration of share entitlements according to law.” Article 7, the Takeover Measures.

\(^{440}\) The following particulars shall be clearly stated in the statement:

1) the name and domicile of the purchaser;
2) the decision of the purchaser concerning the takeover;
3) the name of the listed company to be taken over;
4) the purpose of the takeover;
5) a detailed description of the shares to be bought up and the number of shares scheduled to be bought up;
6) the term and price of the takeover;
7) the amount and guaranteed availability of the funds required for the takeover; and
8) the ratio between the total number of the issued shares of the company to be taken over and the number of such shares held at the time the takeover report is submitted.

Article 82, the Securities Act 1998

\(^{441}\) Article 12, 30, the Takeover Measures 2002

\(^{442}\) Article 90, the Securities Act 2006
applicable rules, as well as to investigate and punish any violation of the rules.\textsuperscript{443} For example, the regulatory agency alone can now determine whether to detain corporate assets that are in danger of dissipation, waste or improper removal.\textsuperscript{444} Previously, the CSRC needed to apply to the courts for asset detention orders, which, for various reasons such as local protectionism, were often refused by the courts.\textsuperscript{445}

To facilitate its supervision and administration over takeovers of listed companies, the CSRC sets up special committees composed of professionals and related experts. These committees, upon the request of the relevant functional departments of the CSRC, provide consultation opinions as to whether or not the takeover of a listed company is constituted, whether or not there is any circumstance under which a listed company may not be taken over, as well as other related matters. Based on the committees’ opinion, the CSRC makes the final decision.\textsuperscript{446} The following subsections will examine the two relevant takeover committees.

\textbf{3.2.1.2 The Takeover Examination Committee}

The Takeover Measures in 2006 brought about a significant change to the internal regulatory within the CSRC whereby a special committee, namely the Takeover

\textsuperscript{443} Article 179, the Securities Act:
The securities regulatory authority under the State Council shall perform the following functions and duties regarding the supervision and administration of the securities market:

1) Formulating the relevant rules and regulations on the supervision and administration of the securities market and exercising the power of examination or verification according to law;
2) Carrying out the supervision and administration of the issuance, listing, trading, registration, custody and settlement of securities according to law;
3) Carrying out the supervision and administration of the securities activities of a securities issuer, listed company, stock exchange, securities company, securities registration and clearing institution, securities investment fund management company or securities trading service institution according to law;
4) Formulating the standards for securities practice qualification and code of conduct and carrying out supervision and implementation according to law;
5) Carrying out the supervision and examination of information disclosure regarding the issuance, listing and trading of securities;
6) Offering guidance for and carrying out supervision of the activities of the securities industrial association according to law;
7) Investigating into and punishing any violation of any law or administrative regulation on the supervision and administration of the securities market according to law; and
8) Performing any other functions and duties as prescribed by any law or administrative regulation. The securities regulatory authority under the State council may establish a cooperative mechanism of supervision and administration in collaboration with the securities regulatory bodies of any other country or region and apply a trans-border supervision and administration.

\textsuperscript{444} Article 180, the Securities Act


\textsuperscript{446} Article 7, the Takeover Measures.
Examination Committee (TEC), was established. The TEC was initially placed as a sub-committee under the Issuance Review Committee within the Department of Public Offering Supervision of the CSRC until 2009, after which the TEC has been assigned to the Department of Listed Companies Supervision.

The TEC is composed of up to 35 members. They are nominated by relevant industrial organizations or relevant regulatory authorities and appointed by the CSRC. Among the 35 members, no more than 7 members shall be coming from the CSRC internal member staffs; the remaining coming from external expertise specializing in the takeover area. Committee members shall hold their office for a term of 2 years unless they resign or get dismissed under extraordinary circumstances. Committee members may be appointed for successive terms, but they shall not hold office more than 4 consecutive years.

The main policy objective of the TEC is to assist in dealing with takeover issues. It is empowered to examine the documents submitted by market participants involved in takeover transactions or the preliminary review report issued by the CSRC.

Based on the assessment report emanating from the TEC, the CSRC makes the binding decision on whether to approve or reject an application for a merger or acquisition. The TEC is also mandated to provide consultancy opinions at the request of the CSRC. Upon request, the TEC must convene plenary meetings to

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448 Artile 8, Operating Procedures of the Listed Company Merger and Reorganization Examination Committee of China Securities Regulatory Commission (Revised in 2014) (The CSRC [2014] No.15)

449 Article 13, ibid

450 Article 7, ibid


452 In details, these examining responsibilities include:

1) to review and verify whether the application for the merger and reorganization of a listed company complies with related conditions;
2) to review and verify the relevant materials and opinions issued by securities service agencies and related persons such as financial consultants, accounting firms, law firms, and asset evaluation institutes, for merger and reorganization matters;
3) to review and verify the preliminary review report issued by CSRC;
4) to produce examination opinions on the merger and reorganization matters.


453 Article 4, ibid
discuss and produce professional opinions on major puzzling issues and innovative matters encountered during their normal examination process.\textsuperscript{454}

Comparatively, the TEC might appear similar to the UK Takeover Panel. However, the TEC does not serve the same functions as performed by the UK Takeover Panel. Rather, the Chinese Committee is merely an internal assisting organ within the CSRC: the CSRC possesses the ultimate regulatory power.\textsuperscript{455} While the UK Takeover Panel carries exclusive jurisdiction over the takeover market, independent from the general securities market regulator, i.e. the Financial Conduct Authority (FCA).

Meanwhile, the CSRC and its TEC also differ from their American counterpart. Although the SEC functions as the similar national general authority with broad supervisory and investigative powers over the securities market in the US, it has a comparatively limited power in regulating stock trading operations. For example, the SEC’s jurisdiction is confined to securities trading rules: it does not interfere with securities issuance-related matters.\textsuperscript{456} In contrast, the CSRC is empowered with the ultimate power to reject or approve securities issuance of listed companies.\textsuperscript{457}

3.2.1.3 The Takeover Expert Advisory Committee

In 2012, the CSRC established another committee namely, the Expert Consultancy Committee (ECC). The ECC is composed of up to 35 committee members. These members can be professionals specializing in law, accounting or asset appraisal, or other experts familiar with industry policies.\textsuperscript{458} Candidates are nominated by the CSRC, or other market institutions; but the final appointment have to be approved by the CSRC. The term of office of the Committee members is 3 years, which may be renewed consecutively.\textsuperscript{459}

\textsuperscript{454} Artile 37, ibid


\textsuperscript{457} Article 118, the Securities Act

\textsuperscript{458} Article 5 set out the requirements for the candidates members under the Working Rules for Expert Consultancy Committee of Merger and Restructuring of Listed Companies (The CSRC [2012] No. 2)

\textsuperscript{459} Artile 3&4, ibid
As the name implies, the ECC is obliged to give expert opinions and provide decision-making support at the request of a functional department of the CSRC. Their duties include:

| (1) Providing Expert Consultancy Opinions on: | i) important difficult problems and innovation matters as well as other similar matters in the formulation and examination of merger and restructuring rules; |
| | ii) the legal, accounting, assets assessment and industry policy issues and other issues as involved in the merger and restructuring regulatory examination; |
| | iii) the merger and restructuring examination standards; |

| (2) Providing Review Opinions on: | i) the appeal filed by the applicant of the merger and restructuring; |
| | ii) the bankruptcy reorganization of listed companies; |

| (3) Other matters as may be required for consultancy in the opinion of the Department of the Listed Companies Supervision and the Takeover Examination Committee of the CSRC. |

The ECC is an *ad hoc* advisory body. It carries out its advisory works in such means as convening plenary sessions, review meetings and special meetings. Where necessary in individual cases, the ECC may set up working groups dealing with law, accounting and asset appraisal matters, with a Chair for each working group. Moreover, the ECC shall convene at least one plenary session each year to study and discuss important issues in the development and regulation of the takeover and restructuring market and summarize the takeover and restructuring work and put forward the opinions and suggestions for the CSRC.

### 3.2.2 The Absence of Judicial Contribution

Chinese courts play a more restrictive, if not invisible, role compared to their counterparts in common law countries such as the US and the UK. Judicial...
passivity in China is largely due to the limited judicial independence from China’s Party-State governance structure.\textsuperscript{464}

Party organs such as the Politics and Law Commissions (Judicial Committee) from the central to local governments oversee all respective legal enforcement authorities including the courts, prosecutors, police forces etc. As a result of the operation of this Judicial Committee, the Communist Party intervenes heavily in the independent adjudications by the courts.\textsuperscript{465}

In addition, the judiciary branch forms part of the bureaucratic government system under the current Chinese political regime. The courts remain administratively and institutionally accountable to the responding level of governments.\textsuperscript{466}

As a response to the passive judiciary system, the Chinese policy makers set out a self-enforcing model for Chinese corporate governance and securities market regulations. This model structures corporate decision-making processes to allow large outside shareholders to protect themselves from insider opportunism with minimal resort to public legal authority especially the courts. As Black and Kraakman suggest, in emerging economies the best legal strategy for protecting outside investors in large companies while simultaneously preserving managers’ discretion to invest is a self-enforcing model of corporate law.\textsuperscript{467} The first Chinese Companies Act as promulgated in 1994, under which few provisions invited judicial intervention in corporate disputes, has been considered a textbook expression of this model.\textsuperscript{468}

The passivity of the courts’ role in China’s corporate governance and securities market is also illustrated by a constant denial of public shareholder’s private enforcement pursuits. Take the \textit{Jiang Shuzhen v. Hongguang Industry Co., Ltd} case
for example. The case was brought to the court in 1997 by shareholder Jiang Shuzhen against a stock issuer, *Hongguang Industry Co., Ltd.* for false and misleading disclosure. The Pudong New District Court in Shanghai refused to accept the case and decreed.\(^{469}\)

*The plaintiff’s case regarding behaviour in violation of laws and regulations in the stock market should be handled by the CSRC. The plaintiff’s suit regarding a securities dispute does not come within the jurisdiction of this People’s Court.*

Moreover, China’s Supreme Court in 2001 issued the *Decree 406* to close the door to civil litigations deriving from wrongdoings within the securities market, including misleading or inadequate information disclosure.\(^{470}\) Even though the Securities Act in 1998 imposed joint liabilities on misbehaving directors, senior managers or underwriters to compensate investors for misleading or inadequate information disclosure,\(^{471}\) In denying the rights of investors to claim damages through the judicial resolution, the Supreme Court defended its stance on the following basis: the ambiguity of existing law, incompetent judges and a lack of clarifying judicial interpretation.\(^{472}\)

In 2003, this ban was partly lifted by another decree of the Supreme Court.\(^{473}\) It is only a partial change because: on the one hand, the procedural and substantive hurdles imposed by the new order made it very difficult, if not impossible, for investors to bring civil actions for compensation against misleading or inadequate information disclosure;\(^{474}\) on the other hand, the cause of available actions is only limited to false disclosure, while the ban on other private securities litigations derived from issues like insider trading or market manipulation has remained in place. Although the Court


\(^{470}\) Notice of the Supreme People’s Court on Refusing to Accept Civil Compensation Cases Involving Securities for the Time Being (No. 406 [2001] of the Supreme People’s Court September 21, 2001)

\(^{471}\) Article 63, the Securities Act 1998

\(^{472}\) See the explanation on Supreme Court: There are Reasons not to Accept Civil Litigation Derived from Securities Transaction at this Moment: [http://www.china.com.cn/zhuanti2005/txt/2001-10/11/content_5065413.htm](http://www.china.com.cn/zhuanti2005/txt/2001-10/11/content_5065413.htm)

\(^{473}\) Provisions of Supreme People's Court on Trying Cases Involving False Statements Related to Securities Market (No. 2 [2003] of the Supreme People's Court)

acknowledged that the ban would be fully removed once “the market and legal conditions are ripe”, the timetable for the removal so far is not clear.\textsuperscript{475}

As a consequence, Chinese courts have not contributed to the regulation of the area of corporate or securities markets, let alone takeover transaction.\textsuperscript{476} This is in sharp contrast to roles as played out by the British courts, not to mention the predominant American courts especially the Delaware Court of Chancery. Nevertheless, this does not mean that the judiciary has not exerted any influence on China’s corporate governance system at all. As an alternative to the case law approach, it is undertaken via Judicial Interpretations issued by the Supreme Court that China’s courts have inserted its influence into companies and securities matters.\textsuperscript{477}

The Chinese Supreme Court has a power to make judicial interpretations for the purpose of implementing national laws.\textsuperscript{478} This judicial interpretation system has been evolving in the past decades to serve, to some extent, as the functional equivalent of case law as observed in the UK and the US.\textsuperscript{479} The most common view emanating from many Chinese academics, lawyers, and judges, is that the Supreme Court’s interpretation constitutes a pre-condition to the application of national law by the courts; many important provisions of the national laws would not be applicable until a judicial interpretation specifically addressing the use of the provision have been issued.\textsuperscript{480} As Randall P. Peerenboom remarks:\textsuperscript{481}

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\textsuperscript{475} Interview with the Vice President Li, Guoguang, available on \url{http://www.dic123.com/A/2/27/27E_110799.html}
\textsuperscript{477} Supreme People’s Court regulations can impact the application of a ‘law” (fa) in three important ways: (i) providing specific authorization for claims already described in principle in statute; (ii) forbidding the acceptance of certain claims; and (iii) providing new legal bases for adjudication beyond what is set forth in statute. Howson, ‘Judicial Independence and the Company Law in the Shanghai Courts’ in Peerenboom (ed), Judicial Independence in China: Lessons for Global Rule of Law Promotion (Cambridge University Press 2010)
\textsuperscript{478} Article 32 of The Organic Law of the People’s Courts of the People’s Republic of China (Adopted in 1979 and revised in 2006) provides:
\textsuperscript{480} For instance, with regard to the use and application of the new PRC Bankruptcy Law 2007, the courts openly refusing to accept bankruptcy cases without a judicial regulation until 2008, when Provisions of the Supreme People’s Court II was adopted. Howson, ‘Judicial Independence and the Company Law in the Shanghai Courts’ in Peerenboom (ed), Judicial Independence in China: Lessons for Global Rule of Law Promotion (Cambridge University Press 2010)
\textsuperscript{481} Randall P. Peerenboom, Business in China: Courts as Legislators (Foundation for Law, Justice and Society 2006)
\end{flushright}
What is distinctive about China’s legal system is that the Supreme People’s Court (SPC) makes law in a much more direct and visible way. Every year the SPC issues a variety of interpretations, regulations, notices, replies, opinions and policy statements (collectively, “interpretations”).

Most are binding upon the courts; others are highly persuasive and likely to be followed by the courts. Sometimes they are rather general; other times they are very specific and issued in response to an inquiry from a lower court in regard to a particular case pending before the court.

In the area of takeover regulations, especially matters regarding hostile takeovers and takeover defensive measures, there has not been a relevant Judicial Interpretation as of yet. The absence of a judicial interpretation on takeover matters further deters the judicial intervention into takeover markets in China.

3.2.3 Concluding Remarks

In sum, the CSRC, a general securities market regulator, is positioned as the predominant regulatory institution for the takeover market in China. This general securities market regulator essentially is one national administrative authority. This administrative regulatory institution, therefore, represents one of the main features of China’s takeover regime, which contrasts to the independent regulatory institution in the UK and the combination of independent federal securities market regulator and state judiciary in the US.

3.3 The Substantive Rules: A Pro Shareholder Approach

The UK and the US have developed contrasting approaches to minimize the conflicts of interests between management and shareholders in the face of a takeover transaction. A pro shareholder approach has been adopted under the UK takeover law whereby a target board shall not adopt frustrating measures without the approval from the shareholders. While a pro management approach has been observed under the US takeover regime whereby a target board has wide discretion to deploy various measures to fend off unsolicited bids. The following section will proceed to examine Chinese substantive rules on anti-takeover tactics.
3.3.1 The Non-Frustration Rule in Chinese Law

Before the promulgation of the Takeover Measures in 2002, the law in China had been silent on this crucial but controversial area.\textsuperscript{482} Article 33 under the Takeover Measures 2002, imposed a general prohibition on directors of a target company to the effect that no defensive measure could be deployed by them to damage the lawful interests of shareholders and the target company as a whole. It further provided a list of measures that must not be adopted once a takeover bid has been announced, except those falling within the sphere of normal business operations or resolutions approved \textit{ex ante} by the shareholder meeting. (Table 3.2)\textsuperscript{483}

Table 3.2, The Prohibited Anti-Takeover Mechanisms

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>To issue shares</td>
<td>To issue any shares or transfer or sell, or agree to transfer or sell, any shares out of treasury or effect any redemption or purchase by the company of its own shares</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>To repurchase shares</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To issue convertible bonds</td>
<td>To issue or grant options in respect of any unissued shares</td>
<td></td>
<td>To create or issue, or permit the creation or</td>
</tr>
</tbody>
</table>

\textsuperscript{482} The Companies Act 1994 provides a principle under which the decision to a merger is resided on the shareholders’ approval. Article 182, the Companies Act 1994. It also provided that when the shareholders’ meeting makes a resolution about the merger or acquisition, the resolution shall be subject to adoption by more than two-thirds of the voting rights held by the shareholders present at the meeting. Article 104, the Companies Act.

\textsuperscript{483} Article 33, Administrative Measures for the Takeover of Listed Companies
issue of, any securities carrying rights of conversion into or subscription for shares

| Assets /Business | To dispose of or purchasing major **assets** or changing the target company’s principal **business**, except for changes to business or restructuring of assets carried out by the company experiencing severe financial difficulties | To sell, dispose of or acquire, or agree to sell, dispose of or acquire, **assets** of a material amount | To dispose corporate **assets** change its principal **business** |
| Contracts | To enter into a **contract** that may have a substantial effect on the target company’s assets, liabilities, interests or results of operations, except in the ordinary course of business | To enter into contracts otherwise than in the ordinary course of business | To make an external investment |
| Articles of Association | To amend the articles of association | N/A | N/A |

The effect of this first attempt to regulate anti-takeover measures is highly questionable. The prohibitive provision under the Article 33 appears too rigid to accommodate the complex takeover practice. On the one hand, the general prohibition is of very limited practical value, since the general corporate system does not provide systematic support in respect of directors’ duties; on the other hand, the list of prohibited measures is both over-inclusive and under-inclusive.\(^484\) It is “over-inclusive” in the sense that it is not certain that the six prohibited measures would definitely damage the interests of the target companies and their shareholders. It is “under-inclusive” in that it is not necessary that any defensive tactic other than the

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listed six would not be abused to the detriment of the interests of the target companies and their shareholders.485

The CSRC in 2006 introduced substantial changes to the Takeover Measures 2002. A new Article 8 was introduced to impose US-style fiduciary duties on the management of a target company.486 The new provision states that that directors should not erect any inappropriate obstacle to a *bona fide* takeover bid; if any defensive measure is initiated, it should be in the interests of shareholders and the target company.487

The Takeover Measure then stipulates a list of duties for target management. For example, the target management must not resign during the offer period;488 the target management bears extensive obligations to accurately, fairly and promptly place before their shareholders all of the facts necessary to arrive at an informed judgment as to the merits or demerits of the offer; the target management must circulate to shareholders their own opinion on the offer; the target management must seek competent independent advice on the offer and communicate the substance of that advice to shareholders;489 the target management must treat all existing and potential bidders equally and not to take such actions as to provide means of financial aid to the purchaser by making use of the sources of the target company.490 If a director fails to perform its fiduciary duty and obligation of due diligence, the CSRC may adopt regulatory measures such as regulatory dialogue and issue of a warning letter, as well as classify the director as an unsuitable practitioner.491

At the same time, the new Takeover Measures abandon the rigid prohibitive model under Article 33 of the Takeover Measures 2002. The revised Article 33 provides that, as a general rule, certain transactions that could frustrate a bid must not be taken from the time a tender offer is announced until its completion; unless in the ordinary course of business, or approved by the shareholder before the announcement of the takeover bid.492 The revised Article 33 then proceeds to limit prohibited transactions to those

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487 Article 8, The Takeover Measures
488 Article 34, ibid
489 Article 32, ibid
490 Article 8, ibid
491 Article 80, ibid
492 Article 33, ibid
having significant effects on the company’s financial condition and business performance. (Table 3.1) Nevertheless, most of these prohibitive measures are beyond the scope of director’s discretion and cannot be initiated without the approval of a shareholders’ meeting under the existing rules according to the Companies Act.493

3.3.2 The Non-Frustration Rule in Chinese Practice

The new Takeover Measures have partly strengthened the substantial rules against defensive measures. Nevertheless, the prescribed provisions are far from an optimal scheme. For example, the unclear definition of “the ordinary business of the company” generates uncertainty about whether significant investment decisions and other activities that may alter the assets of the company and impede hostile takeovers fall into this category. This uncertainty is particularly imminent when taking account of the lack of sophisticated supplementary enforcement institutions such as knowledgeable judges in Delaware Chancery Court, or experienced practitioners within the independent UK Takeover Panel.

Meanwhile, the Takeover Measures only address defensive matters after a takeover bid is officially announced. This post-announcement approach leaves a regulatory gap in relation to the pre-existing anti-takeover measures adopted before the announcement.494 Some of the popular measures include: golden/silver parachutes, supermajority voting provisions, restrictions on the transfer of shares, restrictions on the rights to make resolution proposals to the shareholders meeting, and so on.495

Amongst these measures, the most common one is the staggered board tactic, which restricts the replacement or removal of the target incumbent directors.496 The staggered board provision can be found in many firms.497 A survey of 100 listed

495 See a list of tactics adopted by the exemplary articles of association on the Appendix 3.2
496 The staggered board has been acknowledged as one of the most powerful tactics against unsolicited bidders, especially when combined with the tactics of poison pills. See, for examples, Bebchuk, Coates Iv and Subramanian, ‘The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants’ (2002) 55 Stanford Law Review 885; Bebchuk, Coates and Subramanian, ‘The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy’ (2002) 54 Stanford Law Review 887
497 For example, Article 96 of the Article of Association of GD Midea Holding (Chinese: 美的电器; SZSE: 000527) stipulates that no more than ½ of the number of the directors could be replaced within one year. The article of the association is available on: http://stock.irj.com/share,disc,2012-08-24,000527,000000000000005uqn2.shtml.
companied reports that 50 out of the sample include provisions in their articles of associations to restrict the removal or new appointment of directors.\(^{498}\)

Even without a staggered board of directors, however, the long term of office for directors under the current Companies Act may still have a substantial anti-takeover effect. A listed company in China usually elects its directors triennially after a board serving a term of three years, unless there are vacancies resulting from situations such as resignation or death. Therefore, it may take up to three years to replace the target company’s incumbent directors, depending on when an unsolicited bid is launched. For instance, if the acquirer has launched its bid just before the annual shareholders’ meeting of a target company for election of directors, there will be no substantial delay in gaining control of the target company’s board. However, if a takeover bid is launched immediately after such an annual meeting, the launches will have to wait almost three years for the opportunity to gain control of the target company’s board.

But a board with a long term of office may still be vulnerable to a takeover threat where a director could be removed for no cause, as the UK corporate rule has illustrated.\(^{499}\) The Chinese Companies Act has been silent as to whether a director could be removed without a cause or not. The answer can be found under the Guidelines for the Articles of Association of Listed Companies (The Guidelines), provisions of which are required by the CSRC to be incorporated into Chinese listed companies’ articles of association, except as indicated otherwise.\(^{500}\) The Guidelines 2016 stipulate that the shareholder meeting cannot replace a director without cause during the latter’s term.\(^{501}\) When incorporating this stipulation into its articles of association, a Chinese listed company, in order to minimize any ambiguity that may be taken advantage of by a potential acquirer, may further clarifies or limits circumstances that may give rise to a cause for removal of a director.

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498. Zhang Fang, ‘Effectiveness of the Antitakeover Provisions on Appointment and Removal of Directors in Articles of Association of Companies Listed in China (Shangshi Gongsi Zhangcheng Zhong Dongshi Xuanren Tiaokuan de Youxiaoxing Fenxi)’ (2009) 1 Legal Science (Faxue) 499. For examples, the mandatory provisions on members’ approval of directors’ remuneration report under Section 439, 440, The UK Companies Act 2006; or the mandatory rules that shareholders could remove directors by ordinary resolution at any time before the expiration of his period of office as provided under Section 168, ibid


Of course, an acquirer having secured more than 10% of the shares may request an extraordinary shareholder meeting and propose an amendment to the articles of association, to reduce the term of a board of directors, to relax the conditions of removing a director during her term, or to increase the number of directors.\textsuperscript{502} But this is not an easy task either, since the Chinese Companies Act specifies that any amendment to a Chinese company’s articles of association requires approval by more than two-thirds of present shareholders at a shareholders’ meeting.\textsuperscript{503} Furthermore, under Article 109 of the Companies Act, a PRC listed company is permitted to have no more than 19 directors, which serves to restrain an acquirer’s flexibility to increase a target company’s board size, even if it controls sufficient shareholders’ votes required for an amendment to the articles of association.\textsuperscript{504}

Looking at a hostile takeover case might shed some further light on this set of complicated rules and their application in reality. After becoming the largest shareholder with control of 10.01% of outstanding shares, in 1998 Tianjin Dagang Oilfield (Group) LLC and its related enterprises (Dagang) requested a shareholders’ meeting and intended to change the board of directors of Shanghai Aishi Joint Stock Company (Aishi). However, the Dagang found itself frustrated by Article 67 of the articles of association of the Aishi, which mandates, \textit{inter alia}, strict procedures and special conditions for nominating new directors, also the quota of new directors:\textsuperscript{505}

(1) The board of directors puts forward (or nominates) candidates of directors and supervisors on the condition that the opinions of shareholders have been sought. The candidate list will be sent as a motion to the shareholders’ meeting for discussion and approval.

(2) Shareholders who individually or jointly hold more than 10 per cent of total voting shares of the company (not including share proxy) and have held those shares for more than 6 months shall, if they want to nominate their representatives to the board of directors or the board of supervisors, submit written nominations together with necessary materials to the board of directors 20 days before the shareholders’ meeting is held.

\textsuperscript{502} Article 100&101, the Companies Act
\textsuperscript{503} Articles 44 and 104, the Companies Act
\textsuperscript{504} Article 109, the Companies Act
\textsuperscript{505} Recited from Minkang Gu, \textit{Understanding Chinese Company Law} (Hong Kong University Press 2006), Page 54-55
(3) When the term of the board of directors or board of supervisors has expired and there is a need to form a new one, the number of new directors or supervisors shall not exceed half of the total number that is necessary to form the board of directors or the board of supervisors.

Provisions under this Article 67 evidently delayed, if not denied, the Dagang’s goal to quickly control the management of the Aishi. But the the legitimacy of Article 67 was subject to a fierce debate. Supporters of Article 67 held the view that it was valid because it was just a so called “shark repellant tactic” which was popular in western countries and could serve as an effective measure against the takeover. Opponents of Article 67 held the view that this provision did not comply with Article 4 under the then existing Chinese Company Act 1994.

The CSRC avoided the debate on the legitimacy of this article. Instead, the CSRC ruled that the Aishi’s articles of association were not “standard” according to the Guidelines for the Articles of Association of Listed Companies hence instructed its local office, the Shanghai Securities Administrative Office, to conduct conversations with existing directors of Aishi Company. As a consequence, an extraordinary shareholder meeting was convened on 31 October 1998, whereupon the articles of association were amended to increase the number of directors from 13 to 19, while the 6 new directors were nominated by the Dagang. Therefore, here Dagang Company, as the bidder, successfully gained control of the target Aishi Company.

3.3.3 Concluding Remarks

It appears that Chinese policy makers have adopted a pro-shareholder approach to discourage the use of defensive measures by target management without the shareholders’ approval. This pro-shareholder orientation may be desirable, given that the market for corporate control as a mechanism to monitor and improve the corporate management is urgently needed, particularly during the present transitional economic period in China. Nevertheless, due to the ambiguity of existing rules and the absence of supplementary enforcement institutions, anti-taking measures in practice have been widely adopted by the listed companies in China.

506 Huang, China’s Takeover Law: Regulation and Reform (Vandeplas Publisher 2006)
507 Further discussion will be undertaken in the infra Chapter 7
Conclusion

To conclude, the Chinese takeover regulations have manifested a different regulatory pattern, as compared to the regulations in the UK and the US. As for the first component of the regulatory regime, the regulation framework in China features with a specific administrative law, namely, the Takeover Measures. This administrative law, produced by a ministry level authority, differs from the UK Takeover Code (essentially a self-regulation), also the William Act (federal statute) and Delaware Case Law in the US.

As for the second component of the regulatory regime, the regulatory institution in China features with a ministry level authority, namely the CSRC. This ministry level administrative organ, differs from the UK Takeover Panel (an independent agent), also the SEC (a federal agent) and Delaware Courts in the US.

As the third component of the regulatory regime, the substantive rules in China features with a pro-shareholder approach approximating to the British approach: a non-frustration rule has been adopted in both jurisdictions. But in practice, management under Chinese takeover law enjoy broader power to defend unwelcomed takeover bid. For example, the staggered board a tactic, invalid under the UK law, are well observed in Chinese listed companies.

The multiple regulatory equilibria can be constructed as Table 3.3. Indeed, as Hansmann and Kraakman indicate: “…while convergence may be the word of the day in corporate governance, it is noticeably absent in takeover regulation.”

Table 3.3 Regulatory Heterogeneity of Takeover Markets

<table>
<thead>
<tr>
<th>Jurisdictions</th>
<th>Regulation Framework</th>
<th>Primary Regulatory Institutions</th>
<th>Substantive Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>The UK</td>
<td>Rules-based Takeover</td>
<td>A Designated Regulatory Authority</td>
<td>Pro-Shareholder</td>
</tr>
<tr>
<td></td>
<td>Code</td>
<td></td>
<td>Approach</td>
</tr>
<tr>
<td>China</td>
<td>Rules-based Administrative Regulation</td>
<td>A General Administrative Regulator over the</td>
<td>Pro-Shareholder Approach de jure; otherwise de facto</td>
</tr>
</tbody>
</table>

But why do we see such regulatory heterogeneity in one of the key areas of corporate regulation? Amongst many theories devoted to explaining the diversity, the theory of path dependence has drawn much attention. It has been argued that takeover regulations as part of corporate law are deeply connected to a country’s historical legacy and its political economy context. A takeover regulatory pattern has evolved from a contingent starting point toward today’s pattern on a path conditioned by a mix of historical constraints, and political considerations. Further discussion on the influence of historical legacy and political economy on the takeover regulations will be main focuses of chapter 4-7.


## Appendix 3.2: Anti-takeover Provisions in the Article of Association of the Shanghai Dazhong Public Utilities

<table>
<thead>
<tr>
<th>Type of Defensive Measures</th>
<th>Representative Article</th>
<th>Provisions in Details</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Leveraged Buy Outs</strong></td>
<td>Article 21</td>
<td>The company can repurchase its shares: … (5) if any shareholder who has already individually or collectively possessed ten per cent of the total shares of the company continued to increase its shareholding. Once the circumstances of (5) occurs, the company can immediately repurchase the company’s shares and transfer such shares to any specific third party without any permission or authorization…</td>
</tr>
<tr>
<td><strong>Golden/silver parachutes</strong></td>
<td>Article 37</td>
<td>The shareholders of the company have the following obligations:…(5) if any shareholder who has already individually or collectively possessed ten per cent of the total shares of the company continues to increase its shareholding and become the <em>de facto</em> controller of the company, and as a result the managers of middle-level and above have to (or voluntarily) be dismissed, the new controller should pay one-off extra dismissal fees to such employees unless they give up such fees in writing.</td>
</tr>
<tr>
<td><strong>Special Restrictions</strong></td>
<td>Article 53</td>
<td>Only the shareholder who continuously and individually possesses at least 20 per cent of the total shares of the company for at least three years can bring forwards the proposal on division, merger, dissolve and liquidation of the company, as well as replacement of the directors and supervisors and amendments of articles of association to the general meeting.</td>
</tr>
<tr>
<td><strong>Super-majority</strong></td>
<td>Article 75</td>
<td>The special resolution of the general meeting should be supported both by at least 2/3 voting rights of the shareholders present at the meeting and by the shareholder who individually possesses at least 20 per cent of the total shares of the company.</td>
</tr>
<tr>
<td></td>
<td>Article 110</td>
<td>The appointment and removal of the chairperson of board</td>
</tr>
</tbody>
</table>
of directors should be supported by at least 2/3 of the total directors.

<table>
<thead>
<tr>
<th>Article 117-8</th>
<th>The proposals on division, merger, dissolution and liquidation of the company, revisions of AA and appointment/removal of chairperson of board of directors . . . should be supported by special resolution of the board that requires the support of at least 2/3 of the directors.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Staggered Board</strong></td>
<td><strong>Article 96</strong> The positions of directors, except the independent directors and the director who are the representative of the employees, should not be replaced by more than 1/5 of the total in each term of office.</td>
</tr>
</tbody>
</table>

Source: Articles of Association of Shanghai Dazhong Public Utilities⁵¹²

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Part II: Understanding the Regulatory Heterogeneity from the Path Dependency on Original Conditions

From the Perspective of Path Dependency on Initial Conditions and the Legal Origins Theory

The comprehensive theoretical framework of path dependency includes three main underpinning pillars: multiple equilibria of the regulatory patterns, the sensitive dependence on the initial conditions, and the self-reinforcement effects. The existence of multiple equilibria of takeover regulation has been established in the Part I. This Part will discuss the second defining pillar: what constitutes the initial conditions for the takeover regulation in the UK, the US and China? How have these conditions set the paths for takeover regulation in above jurisdictions?

The explanatory power of the initial conditions will be enhanced with a critical integration of the legal origins theory as developed by law and finance scholarship. The legal origins theory suggests that the historical origin of a country’s legal system is statistically significant for the subsequent development of regulatory styles, and even general economic outcomes.
Chapter 4: Original Conditions of Takeover Regulatory Regime in the UK and the US

Introduction

As we have seen in Chapter 2, the takeover regulations in the US and the UK present two diverse patterns. To interpret this regulatory heterogeneity, this chapter starts from the revisiting the existing discussion on path dependency on initial conditions, and then proceeds to enrich the existing understanding of initial condition path dependency by critically incorporating the well-debated and closely related legal origins theory.

The main section applies the enriched theory of path dependency on initial conditions to inspect what initial conditions, or original conditions constituted the origins of takeover regulations in the US and the UK; how could these conditions account for the rise of various market and regulatory constituencies; and how have different constituencies interacted and determined the inception of the takeover regulations when they commenced in the US and the UK in 1960s.

4.1 Revisiting the Initial Conditions Path Dependency

A persistent dependence on the initial conditions, as introduced in Chapter 1, suggests that a small variation in the original position could account for very large changes in later evolution and settled equilibrium of a dynamical system. The core of a dynamic system that exhibits sensitive dependence on initial conditions may be captured under the quaint tag of the Butterfly Effect: a trivial modification of initial conditions, such as the flapping of a butterfly’s wings, may bring in dramatically different consequences of the dynamic systems.\footnote{Robert C. Hilborn, ‘Sea Gulls, Butterflies, and Grasshoppers: A Brief History of the Butterfly Effect in Nonlinear Dynamics’ (2004) 72 American Journal of Physics 425}
The theoretical development of the theory of path dependency on initial conditions can be attributed to economic historians, especially Paul Allan David and William Brian Arthur. Both David and Arthur have documented the critical position of initial events setting in areas including the innovation and evolution of various technologies, the institutional and economic development of society. Technologies, institutions and economies are established against historical contexts set out by initial conditions since “extraneous features of these conditions may become enduring constraints.”

Corresponding to David and Arthur’s interpretations of the dependence on initial conditions, political scientists have developed concepts such as “critical junctures” or “conjunctures” to examine the dynamics of initial condition path dependency in the political science field. These “critical junctures” or “conjunctures” are generally referred as the “interaction effects between distinct causal sequences that become joined at particular points in time”. They have been attributed to influence the pattern of a political systems in different countries. They set institutional arrangements on paths, which at a later point in time are very difficult to alter. As Pierson and Skocpol state:

A clear logic is involved in path dependent processes in a political system: outcomes at a critical juncture trigger feedback mechanisms that reinforce the recurrence of a particular pattern into the future.

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514 Section 1.3, Theoretical Framework; Chapter I: Introduction.
516 Paul A. David, ‘Why are Institutions the ’Carriers of History’?: Path Dependence and the Evolution of Conventions, Organizations and Institutions’ (1994) 5 Structural Change and Economic Dynamics 205
517 And other equivalent notions such as the chaos theory underlying the persistent influence of contingent beginnings. According to Stephen H. Kellert, the focus of the chaos theory is on the unstable aperiodic behaviour under a dynamic system:
518 Unstable aperiodic behaviours are highly complex because they do not repeat themselves but carry on manifesting the effects of small perturbations... A dynamical system that exhibits sensitive dependence on initial conditions will produce markedly different solutions for two specifications of initial states that are initially very close together. See further in Stephen H. Kellert, In the Wake of Chaos: Unpredictable Order in Dynamical Systems (University of Chicago Press 1993)
520 Pierson and Skocpol, ‘Historical Institutionalism in Contemporary Political Science’ in Katznelson and Milner (eds), Political Science: The State of the Discipline (New York: W.W. Norton and Company 2002)
In the field of legal research, the scholarship has also endeavored to examine critical roles that the initial conditions of diverse legal traditions and regulatory strategies have played throughout the paths of legal evolution and its impacts on the economic development. In a series of path-breaking articles, a group of law and finance scholars, most prominently La Porta, Lopez-De-Silanes, Shleifer, and Vishny (La Porta et al.), have accumulated and presented various data about the relationship between different legal origins – especially the common law system and the civil law system – and the quality of law as well as levels of financial/economic development across jurisdictions. As a direct result of this research, a so-called legal origin theory appears to suggest that the historical origin(s) of a country’s legal system has overwhelming effects on its current legal system and economic performance.

4.2 Enriching the Initial Conditions Path Dependency with the Legal Origins Theory

The theory of legal origins has attracted substantial critiques. This section presents a critical analysis of the legal origin theory and incorporates the legal origin theory into the initial conditions path dependency. The legal origins theory claims that the crystallization of legal infrastructures in the case of most countries, which is still influencing the enforcement even the content of substantive rules, occurred at some point in the late 19th century or at the latest in the early 20th century.

4.2.1 Overview of the Legal Origins Theory

The legal origins theory proclaims strong and pervasive effects of legal origins on diverse spheres of law making and regulation, which in turn influence a variety of economic outcomes. As stated by La Portal et al.

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522 See also figure 2, Porta, Lopez-de-Silanes and Shleifer, ‘The Economic Consequences of Legal Origins’ (2008) 46 Journal of Economic Literature 285
523 These spheres include, inter alia, company law, securitites law, labor law, and many others. For a full list of legal areas with documented influence of legal origins, please refer to the Figure 2, ibid
524 See in general, Deakin and Pistor (eds), Legal Origin Theory (Edward Elgar Publisher 2012)
There is by now a great deal of evidence that legal origins influence legal rules and regulations, which in turn have substantial impact on important economic outcomes – from financial development, to unemployment, to investment and entry, to the size of unofficial economy, to international trade.

The legal origins theory traces the regulatory styles of common law and civil law to historical perception about law and regulatory strategies that English and French developed centuries ago. The common law system, compared to the civil law system, is associated with the greater judicial independence and the lower formalism of judicial procedures, which indicate better contractual enforcement and greater protection of individual property rights against state expropriation. On the other hand the civil law system is less effective than the common law system in reducing the chance for wasteful rent-seeking. Because the legislature plays a more important role within the civil law system than in the common law system. As a result, a higher likelihood of regulatory capture exists within the civil law system.

The historical perception and regulatory strategies were incorporated into the later evolution of different legal systems, substantive legal rules, human capital and legal ideologies of regulatory participants. When common law and civil law spread into much of the world through conquest and colonization, the embedded features are transplanted as well. Despite much adaption and localization, the fundamental strategies and features of each legal system survived and have continued to exert substantial influence on economic outcomes.

In a recent work, La Porta et al. suggest that legal origin cannot be regarded as a good instrument for the quality of legal rules because it is likely to affect economic outcome variables in a number of different ways. In particular, they suggest that legal origin, understood in the broad sense of “regulatory style,” could be influencing the economy not through the quality of legal rules alone, or even predominantly via this

526 See ibid
527 Ibid
529 The civil law system hence tends to advance institutional developments that enhance the State power with negative effects on the financial development. Thorsten Beck, Asli Demirguc-Kunt and Ross Levine, ‘Law and Finance: Why Does Legal Origin Matter?’ 31 Journal of Comparative Economics 653
route, but through alternative aspects of the legal infrastructure, such as enforcement mechanisms or prevailing modes of legal interpretation.\footnote{See Porta, Lopez-de-Silanes and Shleifer, ‘The Economic Consequences of Legal Origins’ (2008) 46 Journal of Economic Literature 285}

It is suggested that legal origins have delivered the residual influence through two distinct channels to determine the features of current legal systems, the quality of the law, and the development of the real economy.\footnote{Thorsten Beck, Asli Demirguc-Kunt and Ross Levine, ‘Law, Endowments, and Finance’ (2003) 70 Journal of Financial Economics 137; Beck, Demirguc-Kunt and Levine, ‘Law and Finance: Why Does Legal Origin Matter?’ 31 Journal of Comparative Economics 653} The first is the so-called “political channel”. The political channel postulates that legal origins imposed different sets of priority on the state power relative to private property rights, which constitute the basis of contrasting regulatory styles and diverse financial developments.\footnote{Beck, Demirguc-Kunt and Levine, ‘Law and Finance: Why Does Legal Origin Matter?’ 31 Journal of Comparative Economics 653}

The second is known as the “adaptability channel”. It emphasizes that various legal traditions respond differently to changing socioeconomic conditions. Different legal origins with historically different levels of flexibility explain contrasting regulatory styles and various levels of financial developments; an inflexible legal tradition might lack legal capabilities to catch up with commercial needs efficiently.\footnote{Ibid}

The political channels and adaptability channels respectively seem to make some different predictions concerning the mechanism through which different legal origins influence the development of laws and financial markets. Nevertheless, the two channels are not exclusive to each other but rather remain complementary to each other.\footnote{These dual channels, indeed, can be seen as complementary to each other, as, for example, implied by Hayek’s analysis of the variances between the civil law and the common law. Friedrich A. von Hayek, The Constitution of Liberty (University of Chicago Press 1960); Friedrich A. von Hayek, Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy (University of Chicago Press 1973); Beck, Demirguc-Kunt and Levine, ‘Law and Finance: Why Does Legal Origin Matter?’ 31 Journal of Comparative Economics 653} They form two interconnected components of the law and finance approach to legal evolution and financial development.\footnote{James Mahoney, ‘Path Dependence in Historical Sociology’ (2000) 29 Theory and Society 507; Armour and others, ‘Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis’ (2009) 6 Journal of Empirical Legal Studies 343} A causal relationship hence can be drawn as follows on the legal origins theory:

\footnote{\S 530} See Porta, Lopez-de-Silanes and Shleifer, ‘The Economic Consequences of Legal Origins’ (2008) 46 Journal of Economic Literature 285


\footnote{\S 533} Ibid

\footnote{\S 534} These dual channels, indeed, can be seen as complementary to each other, as, for example, implied by Hayek’s analysis of the variances between the civil law and the common law. Friedrich A. von Hayek, The Constitution of Liberty (University of Chicago Press 1960); Friedrich A. von Hayek, Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy (University of Chicago Press 1973); Beck, Demirguc-Kunt and Levine, ‘Law and Finance: Why Does Legal Origin Matter?’ 31 Journal of Comparative Economics 653

4.2.2 Incorporating the Legal Origins Theory to the Initial Conditions
Path Dependency

The preceding overview showed that law and finance scholars presuppose certain “stylized facts” about various legal origins, especially the common law and the civil law. But this presupposition is neither original nor innovative. The twofold typology as utilized in the legal origins theory is rather rooted in the profound knowledge pool of comparative law scholarship in categorizing varying legal systems.

For example, David and Brierley propose a tripartite division of Western law into the common law, the Romano-Germanic law, and the socialist law.\textsuperscript{536} While according to Merryman and Pérez-Perdomo, neither French law nor German law is the representative for the civil law tradition; they are merely two of many subclasses of civil law systems.\textsuperscript{537} Similarly, Dawson’s often cited historical narrative of the transformation from lay to professional judges in England, France, and Germany

\textsuperscript{536} David and Brierley, \textit{Major Legal Systems in the World Today} (Legal Classics Library 2000)
\textsuperscript{537} In the case of France because of its revolutionary roots, and in the case of Germany because of the large influence German scholars exerted on their jurisprudence. See generally, John Henry Merryman and Rogelio Pérez-Perdomo, \textit{The Civil Law Tradition: An Introduction to the Legal Systems of Europe and Latin America} (Stanford University Press 2007) Also Ulrike Malmendier, ‘Law and Finance at the Origin’ 47 Journal of Economic Literature 1076
treats these countries as regions with distinct histories and institutions; although this does not suggest that they are exhaustive typologies of legal systems.\textsuperscript{538}

The veracity of this conventional classification of legal families has been subject to challenge. For example, Ugo A. Mattei has argued the presumption that judges in civil law countries are bound to apply the strict legal text of the code via the rigid deductive, while judges in the common law countries have discretion to shape rules to changing economic circumstances, is “dramatically misleading, being based on a superficial and outdated image of the differences between the common law and the civil law”.\textsuperscript{539} Despite of the fact that the drafters of the French civil code meant to limit the independence of judges via avoiding the doctrine of judicial precedent, “neither before nor after the French codification could any of the civil law systems be fairly characterized as the one described by the French post-revolutionary scholars”.\textsuperscript{540}

Meanwhile, Markesinis and others have documented the prominent role of decision-making by the judicial branch regarding legal innovation within the civil law world.\textsuperscript{541} Teubner and Pistor have also shown that doctrines that are regarded as being at the core of the distinctive civilian approach to economic regulation, such as the application of the concept of good faith to commercial contracts, were judicial innovations.\textsuperscript{542}

Moreover, looking beyond these stylized facts about legal families, assumed by legal origins adherents, one can easily find that the vast majority of rules in the areas of commercial law are statutory in both the common law and civil law countries.\textsuperscript{543} The

\textsuperscript{538} John Philip Dawson, \textit{A History of Lay Judges} (Lawbook Exchange 1999)

\textsuperscript{539} Ugo Mattei, \textit{Comparative Law and Economics} (University of Michigan Press 2004) Page 79
\textsuperscript{540} Ibid Page 83


growth of the corporate law or the securities law in the common law jurisdictions since the mid-twentieth century has meant that common law judges have comparatively limited freedom to maneuver in interpreting statutes and innovating case law;\(^{544}\) while civil law judges have secured broader powers to develop corporate rules by referring to general clauses, such as the bona fide clause, which ameliorate the ostensible rigidity of the comprehensive civil/commercial code.\(^{545}\) As prominent company law scholars suggests:\(^{546}\)

*Contrary to what an earlier generation was taught at Law Schools in the Civil Law countries judges have greater freedom to make law (albeit on the basis of codified general principles), while in the United Kingdom it is increasingly made by statute and judges are inhibited from developing new principles by the extent and detail of the statutory intervention.*

More importantly, before examining different channels and affirming the robustness of the results, one must first determine which legal family does one legal system belong to.\(^ {547}\) Having pointed out that most of jurisdictions contain hybrid elements drawn from both the common law and civil law traditions, Glenn and Siems have raised the question whether a legal system can be even categorized neatly into a specific legal family as proposed under law and finance scholars.\(^ {548}\) Close inspection has revealed the rampant phenomenon of cross-fertilization and hybridization across different jurisdictions.\(^{549}\) Even representing countries at the core of either the common

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\(^{546}\) Paul Lyndon Davies and Laurence Cecil Bartlett Gower, *Gower and Davies’ Principles of Modern Company Law* (6 edn, Sweet & Maxwell 1997) 8


\(^{549}\) The ancient Roman case illustrates another reason why it is not easy to assign different legal systems with distinct features into different groups. The case-based evolution of early Roman law, in particular, suggest that the more rigid character of codified legal systems represented by civil law jurisdictions seems to be the result of later developments, not present at “its origin.” See for examples, Malmendier, ‘Law and Finance at the Origin’ 47
law system or the civil law system have exchanged legal rules, practical experience or regulatory institutions from each other outside of their camps.\textsuperscript{550}

For example, La Porta et al treat the Japanese legal system as being of German legal origin.\textsuperscript{551} (Appendix 4.2) At the end of the 19\textsuperscript{th} century, Japan did transplant substantial parts from the German Civil Code; but after the World War II, Japanese Commercial Code has changed very significantly owing to the American influence.\textsuperscript{552} As a result, the law and finance categorization of most countries of the world according to a small number of legal families is, to a large extent, arbitrary.\textsuperscript{553}

These criticisms,\textsuperscript{554} do not suggest that one should altogether abandon the legal origins theory to interpret the legal evolution and economic development. Essentially, the legal origins hypothesis claims that the crystallization of a particular legal infrastructure or order, which in the case of most countries occurred at some point in the 19\textsuperscript{th} century or at the latest in the early 20\textsuperscript{th} century, is still influencing the content of substantive rules, their enforcement, and thereby causing a range of economic outcomes.\textsuperscript{555} The law and finance research have presented a variety of connection among legal origins, particular legal rules and economic outcomes. (Appendix 4.1)

\textsuperscript{551} For example, as the dynamic centre of world legal evolution for the past century, the United States has shoehorned many of its rules and institutions into civilian legal countries. See Ohnesorge, ‘China’s Economic Transition and the New Legal Origins Literature’ (2003) 14 China Economic Review 485; also Robert Charles Means, Underdevelopment and the Development of Law (University of North Carolina Press 1980)
\textsuperscript{552} Porta, Lopez-de-Silanes and Shleifer, ‘The Economic Consequences of Legal Origins’ (2008) 46 Journal of Economic Literature 285
\textsuperscript{553} Mathias M. Siems, Convergence in Shareholder Law (Cambridge University Press 2008)
\textsuperscript{554} This is also in line with insights from general comparative law, as even comparative lawyers who still apply the notion of legal traditions emphasize the limits of this notion. For instance, legal traditions are said to be just “a loose conglomeration of data,” the idea of legal families “is used purely for explanatory purposes,” and even if “we mostly continue to divide the world into civil law, common law, and several other systems ... we know that these are ideal types which merely serve our need to maintain a rough overview.” Glenn, Legal Traditions of the World: Sustainable Diversity in Law (Oxford University Press 2004); Zweigert, Kotz and Weir, An Introduction to Comparative Law (Clarendon Press 1998); René David and John E. C. Brierley, Major Legal Systems in the World Today: An Introduction to the Comparative Study of Law (Legal Classics Library 2000)
\textsuperscript{555} Or even at some point in the twelfth and thirteenth century, as claimed by some law and finance scholars; see the references in Siems, ‘Legal Origins: Reconciling Law & Finance and Comparative Law’ (2007) 52 The McGill law journal 55.
This claim suggests a very strong form of path dependence linked to initial conditions: “the legal system provides the fundamental tools for addressing social concerns and it is that system, with its codes, modes of thought and even ideologies, which is very slow to change.”\textsuperscript{556} The inherited legal origin effect is, therefore, said to influence even those areas of regulation which have arisen comparatively recently: “…securities laws are creatures of the twentieth century ... yet ... these laws took different forms in countries from different legal traditions, consistent with broad strategies of how the law intervenes.”\textsuperscript{557}

4.3 Original Conditions for Takeover Regulation in the US

The US takeover regulation is an amalgam of federal and state law.\textsuperscript{558} At the federal level, the regulation has taken the form of securities laws, most notably the Williams Act 1968; other rules as prescribed by the securities market regulator, namely, the SEC. At the state level, the regulation has taken the form of anti-takeover statutes, and more importantly, the case law as developed by the courts in the state of Delaware.\textsuperscript{559} The following three sections will examine the original conditions of American takeover regulations from both the federal and the state level.

4.3.1 Suppression of Institutional Investors

At end of 19\textsuperscript{th} century, the two largest financial institutions in the US were insurers and banks. But shortly after, government initiatives were placed to curb the growth of insurance companies and to fragment big banks. Consequently, both financial institutions consequently were “neutralized” at the beginning of the 20\textsuperscript{th} century. Later in the 1930s, the New Deal Reform reinforced the fragmented financial institutions in the US further. As a result, long before the takeover regulation pattern came to shape in 1960s, the American institutional investors had been preempted from the position as the dominant securities market constituencies; hence they lack the power to exercise determinant influence on the shaping of the takeover regulations in the US.

\begin{footnotes}
\item[556] Porta, Lopez-de-Silanes and Shleifer, ‘The Economic Consequences of Legal Origins’ (2008) 46 Journal of Economic Literature 285
\item[557] Ibid
\item[559] For further discussion on the US takeover regulatory system, please refer to supra Section 2.1.2, Chapter 2.
\end{footnotes}
4.3.1.1 Suppression of Insurance Companies

By the end of 19th century, insurers in the US had emerged as one of the largest American financial institutions. These insurers were involved in underwriting securities, buying bank stock and controlling large banks, and assembling securities portfolios with control potential.560

In 1905 explosive scandals appeared epidemically within the insurance industry.561 The legislature of New York State, where half of the nation’s insurance assets were based, responded with a political inquiry, called the Armstrong Investigation after the state legislator who chaired the investigative committee.

The four-month-long Armstrong Investigation made startling revelations of problems such as nepotism, insider financial chicanery, or bribery of legislatures. The Investigation also make a number of recommendations, the most critical of which were to forbid the most popular form of life insurance like tontine insurance, to limit the growth of life insurers including several of the then nation’s largest insurers, and to prevent insurance firms from owning the stock of other companies.562

These recommended measures curved the growth of insurance companies and the expansion of insurance industry. But such a restriction of insurers’ operation or prohibition of insurers’ stock ownership was not directly due to the concern that stocks were too risky for insurance companies. Rather, it was due to the perceived fear that growing insurance companies would have too great control over other companies. As Charles Evans Hughes pointed out in his submitted Armstrong Committee Report:563

> Insurance companies might extend their control of ancillary banks and trust companies to control of railroads and industrial enterprises...The officers and members of finance committees of life insurance companies are in

positions of conspicuous financial power...Accordingly, investments in stocks should be prohibited.

In 1906, lawmakers of the New York State approved all of the recommended measures as made by Charles Evans Hughes and pass a number of bills to amend the then New York Insurance Law § 70. The amended New York Insurance Law, *inter alia*, officially prohibited insurers from owning stock, from controlling banks, and from underwriting securities.564

In the following decades of the 20th century, the legacy of prohibiting insurers’ stock ownership endured. For example, the SEC in 1940 proposed that insurance companies should be allowed to invest in stocks.565 But the New York State objected this proposal and reiterated the fear as reported by the Armstrong Investigation, “if lawmakers allowed a little stock investment…they would not stop there: eventually insurance companies would control industry.”566 It was only until 1951, the New York legislature for the first time eased the absolute ban. Nevertheless, a cap was still imposed to restrict insurers from holding more than 2 per cent of the voting stock of any portfolio company.567

As a result, insurers were heavily regulated, if not deprived, from owning stocks for half a century until the 1980s when a deregulation of the ban on stock ownership by insurance companies occur.568 But by that time, it was already too late for insurance companies to re-garnet its power and exercise an influence on the already formed American takeover regulation pattern as shaped by other institutions.

564 N.Y. Insurance Law §§ 46-a, 78.2, 81.13(b) and 227.1(b)
565 To account for its proposal, the SEC indicated that: on the one hand, bans on institutional stock investment by insurance companies had led to overemphasis upon debt financing by industrial companies, which would cause financial chaos; on the other hand, British life insurance companies have successfully invested their funds in stock over a period of many years. Commissioner Pike of SEC Wants Life Companies to Buy Common Stocks, The Eastern Underwriter, Oct. 24, 1941, at 7. See also Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press 1994)
566 Ibid Page 81
567 N.Y. Insurance Law §§ 46-a, 78.2, 81.13(b) and 227.1(b)
4.3.1.2 Fragmentation of the Banking Sector

For a long period, the small State banks have been dominant in the American banking system. The scene was changing in the mid of 19th century. Large national intermediaries were appearing on the horizon as large-scale national industries become predominant in the American economy. In particular, the Second Bank of the United States presented strong signs to become the first of the national intermediaries. The Second Bank, chartered in 1816, has been coordinating complex financial transactions running through its many branches across the nation parallel to the flow of inter-state trade, making it “the first prototype of modern business enterprise in American commerce.”

The Second Bank, nevertheless, did not transferred to be the first American national financial intermediary. As President Andrew Jackson vetoed to renew the charter of the Second Bank in 1832, the Second Bank ceased to function in 1836 upon the expiration of the Bank’s charter and underwent liquidation in 1841.

As similar to the fear as pointed out in the Armstrong Committee Report, the President opined that the Second Bank had the potential to be run or exploited by a small group of people: “It is easy to conceive that great evils to our country and its institutions might flow from such a concentration of power in the hands of a few men irresponsible to the people.”

Small changes in earlier conditions can vastly affect later outcomes. Jackson’s veto and the destruction of the Second Bank was a “cataclysmic event” for American banking development. It left the United States without a strong, national banking system. A fragmented banking system deeply influenced financial market development in the country for the next century and a half.

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572 Mark J. Roe, ‘Capital Markets and Financial Politics: Preferences and Institutions’ (2012) 7 Capitalism and Society 1
The reform of New Deal further fragmented American banking industry by reforming the operation of business and finance in the US. For a long time, banks in America have engaged in the stock market indirectly through their affiliates, although the National Bank Act of 1863 and 1864 had already sever banks from direct stock ownership. By 1930 when the Great Depression arrived, nearly half of the new offerings in the US stock market went through bank affiliates.

With the crash of the stock market and the failure of thousands of banks, the New Deal Congress concluded that it was the operation of bank affiliates that had resulted in bank failures, which directly caused the Depression. It was held that a bank whose affiliate sold securities had a severe conflict of interest and that this interest conflict could only be remedied by severing the securities-selling affiliate from the bank.

The key relevant initiative taken by the New Deal Congress is enactment of banking regulations, in particular the Glass-Steagall Act. Passed in 1933, the Glass-Steagall Act separated commercial and investment banking. It barred bank affiliates from owning and dealing in securities, thereby separating investment banks from commercial banks. As a result, the preexisting fragmented framework endured and entrenched, and banks, similar to the insurance companies, are also precluded from becoming significant players in the governance of corporations in the US.

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573 The National Banking Acts of 1863 and 1864 were two United States federal banking acts that attempted to assert federal control over the banking system without the formation of a central bank. The Act had three primary purposes: (1) create a system of national banks, (2) to create a uniform national currency, and (3) to create an active secondary market for Treasury securities to help finance the Civil War (for the Union's side). See further discussion on: Edward Flaherty, ‘A Brief History of Central Banking in the United States’ American History: From Revolution to Reconstruction and Beyond <http://www.let.rug.nl/usa/essays/general/a-brief-history-of-central-banking/> accessed 01 January, 2016


576 Another notable banking regulation is the Federal Deposit Insurance Corporation Act 1933, which mandated federal deposit insurance and preserved small-town banks. Carter H. Golembe, ‘The Deposit Insurance Legislation of 1933: An Examination of Its Antecedents and Its Purposes’ 76 Political Science Quarterly 181

4.3.2 Establishment of a Federal Regulator and Its Authority

Conventionally, there had been little regulation over the securities market from the US federal government. Instead, the securities market had been largely self-regulated by private market participants such as the New York Stock Exchange. Reflecting on the Great Depression, the New Deal reformers believed that long existing self-regulation model was inadequate and government regulation was mandated. Hence two federal acts, namely the Securities Act of 1933 and the Securities Exchange Act of 1934, were swiftly enacted to implement government intervention and to correct and stabilize the tumbling financial market.

As for the takeover market, the enactment of both Acts has two direct effects. The first effect is a new federal system of information disclosure and antifraud regulation over the securities transaction is established. The second effect is that a new federal government agency, namely the SEC, is created to oversee the stock exchanges and to police the American securities markets.

These effects have enduring influence on the regulation of securities market in the US. On the one hand, it means, the primary source of securities regulation in the US would be mandatory federal law that focuses on transaction transparency and procedure; on the other hand, securities regulation in the US would be primarily overseen by Federal government particularly the SEC, rather than self-regulatory adjustments by stock exchanges as previously functioned.

The legacy of the 1930 New Deal Reform were reinforced three decades later. In 1968, the Federal Congress passed the Williams Act as amendments to the Securities Exchange Act of 1934 to respond to various malpractices as appeared in the increasing utilization of hostile tender offers. The primary purpose of the Williams Act, as discussed in the Chapter 2, was to ensure full and fair disclosure for the

benefit of stockholders, while at the same time to ensure the neutrality policy between bidders and target management. To serve this purpose, it imposed a broad prohibition against the publication of false, misleading, or incomplete statements in connection with a tender offer.581

As for its implementation, the Williams Act re-affirmed the SEC as the general regulator over the securities market. It mandated the report filing and public disclosures with the SEC.582 It empowered the SEC the authority to produce its own rules to implement the Williams Act, to investigate or prosecute violations of relevant regulations.583

In furtherance of the enforcement of the Williams Act, the SEC has issued Regulation 13D pursuant to the Williams Act, which requires the disclosure of important information by anyone seeking to acquire more than 5% of a company’s securities by direct purchase or tender offer. Regulation 13D further specifies the format and disclosure requirements for statements made on Schedule 13D and Schedule 13G. Outside of these formal regulations, the SEC also engages in soft law makings by issuing concept releases, interpretive releases, policy statements and others to ensure the transparency and fair procedure during a takeover truncation.584

The SEC has also adhered to the neutrality policy between bidders and target managers as its mantra throughout. As the SEC Chairman Manuel Cohen put it: “The principal point is that we are not concerned with assisting or hurting either side. We are concerned with the investors who today is just a pawn in a form of industrial warfare…this is our concern and our only concern.”585

Nevertheless, the SEC has not received further extensive powers to regulate takeover transactions. Its authority is still limited to ensuring adequate disclosure and after-the-

581 See further discussion on supra section 2.1.2.1 The Specific Federal Rules: The Williams Act, Chapter 2.
582 For example, the Act requires anyone who acquires more than 5 per cent of the outstanding shares of any class of a corporation to disclose to the SEC the source of the funds, the purpose for the offer, etc. Copies of these disclosure statements must also be sent to each national securities exchange where the securities are traded, making the information available to shareholders and investors.
583 See further discussion on supra section 2.2.2.1 The Role of General Federal Regulator: The SEC, Chapter 2
584 Ibid
585 The statement of Manuel Cohen, Chairman of the SEC, at Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Sub-committee on Securities of the Commission on Banking and Currency. 90th Congress 43 (1967)
fact policing of fraud, another legacy of the New Deal package of reforms. In the face of the deprived regulation by self-regulators and the limited regulation by federal regulators, a regulatory gap over takeover transaction has been left. It’s against this regulatory composition that the Delaware state courts stepped in and started developing substantial rules to regulate takeover transactions especially when it became epidemic in 1980s. The following section proceeds to examine the rise of State Courts of Delaware as the predominant regulator over the American takeover market.

4.3.3 Rise of State Courts of Delaware as the Predominant Regulator

As discussed in chapter 2, when the wave to hostile takeovers surged in the 1980s, it was the State of Delaware, where most of the large corporations were registered, that provided the most competent judges to deal with those sophisticated takeover cases. But the original conditions for Delaware Courts to become the leading sources of takeover regulations in the US were laid much earlier.

4.3.3.1 Rise of Delaware as the Leading State of Incorporation

For a long time, the State of New Jersey had been the leading state for incorporation of large corporations before the State of Delaware began to emerge as the new preferred forum for incorporation. Things changed at the turn of the 20th century when the State of Delaware, seeking new sources of revenue, began a variety of new initiatives to encourage incorporation. For instances, in 1897, Delaware adopted a new constitution, permitting incorporation under general law instead of by special legislative mandate. Later in 1899, the Delaware’s General Corporation Law (DGCL) was enacted modeling largely after the 1896 New Jersey corporate statute, which was regarded as the first of the modern liberal corporation statutes in the US.

Then in 1913, at the insistence of Governor Woodrow Wilson, New Jersey drastically tightened its law relating to corporations and passed antitrust laws inhospitable to

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corporations. These new regime outlawed attempts to create monopolies or suppress competition and forbade the chartering of any new holding companies. Consequently, the number of corporations incorporated in New Jersey declined precipitously. Delaware, with its newly adopted DGCL that retained the relatively liberal provision as initially provided under the New Jersey statutes, appealed to many companies fleeing New Jersey. By 1915, the Delaware corporation law was commonly regarded as a modern and “liberal” act.\textsuperscript{590}

The status of Delaware as the leading forum for corporate registration was further strengthened with the 1967 reform on its 1899 DGCL. When mergers and acquisitions activity intensified in 1960s, the federal lawmakers responded with initiatives such as the 1968 Williams Act. The state lawmakers in Delaware also reacted with one important corporate law reform. This reform is the 1967 amendment to the 1899 DGCL, which has been praised as “the most sweeping corporate law reforms” since the DGCL was enacted in 1899.\textsuperscript{591}

The predominant purpose of the 1967 amendment is to insure simplified corporate practice and procedure by vesting wide discretion into the board of directors. Among many key changes were a sharp expansion of the powers of a corporation to indemnify its directors, an attempted codification of the standard for reviewing self-interested transactions, a provision authorizing cash-out mergers, and a reduction of the availability of appraisal rights.\textsuperscript{592}

“More important than the details was the overall effect of the reforms.”\textsuperscript{593} Although none of the major changes were directly aimed at the surge in hostile takeover bids, the reforms addressed concerns that had frequently been raised by managers. For examples, expanded indemnification provided more protection against the possibility of fiduciary duty litigation, and retrenchment on appraisal rights smoothed the skids for large corporations that had embarked on acquisition campaigns.

As a result, when the biggest judicial challenges to hostile takeovers began, Delaware had firmly secured its preeminence as the leading state of incorporation of large

\textsuperscript{590} Ibid
\textsuperscript{592} Ibid
\textsuperscript{593} Ibid
corporations. But one more condition is needed to induce large judicial challenges to make their way through the Delaware courts, and to finally set the Delaware courts as the main sources of takeover regulations in the US. This condition is that the state courts, not the federal courts, shall retain jurisdictions over disputed takeover transaction. This condition is fulfilled by the decision of two landmark cases.

4.3.3.2 Landmark Cases Sets the States Courts as the Main Forum for Takeover Regulation

The current corporate governance in the US features a dual system, under which the federal government exercises the power to create and define laws regulating the national securities markets, while the states retain the power to create and define corporate law. During the 1960s the situation was different: far more corporate cases were being dealt by the federal courts rather than by the state courts.

The first main reason is that State courts including Delaware’s were less shareholder-friendly, in contrast to federal courts. Another main reason is that as most of the corporate actions were brought into the federal courts as securities law cases pursuant to the Section 10(b) of the Securities Exchange Act of 1934 and the SEC Rule 10b-5, which prescribe what conducts would be classified as fraud operations. That situation became so pronounced that, by 1965, leading members of the American corporate defense bar were predicting that state corporate fiduciary enforcement would become de facto federalized under the federal securities law.\(^{594}\)

Nevertheless, two historical judicial decisions in 1970s foreclosed possible federalization of corporate law issues and reserve the jurisdiction over the takeover market for the State courts, primarily for the Delaware courts.

The first historical decision was delivered in 1971 by the Delaware Supreme Court in the case of Schnell v. Chris Craft Industries.\(^{595}\) In this case, directors of Chris-Craft were concerned because some shareholders had announced that they planned to replace some directors at the next shareholder meeting. As a tactical response, the directors moved the annual meeting from January to December, making it more difficult for shareholders to make travel arrangement and to show up to vote out the

\(^{594}\) Ibid 
directors. Some shareholders including Schnell sued to enjoin the directors from advancing the date of the annual shareholders’ meeting.

Under the by-laws of the company, and under the DGCL, it was legal for the directors to change the date of a shareholders meeting, once they have given 60 days’ notice in advance. In this case, the directors did give the proper notification according to the by-laws and the Delaware law. The Court of Chancery found in favor of the directors. But the Delaware Supreme Court, upon the appeal by the shareholders, reversed the ruling by the Court of Chancery.

In the final decision, as an answer to the appellee’s defense that “it has complied strictly with the provisions of the new Delaware Corporate Law in changing the by-law date”, the Delaware Supreme Court holds that “inequitable action does not become permissible simply because it is legally possible.” This decision constitutes a watershed in the evolution of American corporate law because it began an irreversible doctrinal development whereby equitable notions of fairness came to overlay judicial review of board decisions in settings far beyond contests for control.

As a consequence, the Delaware courts shed their previous institutional management-oriented bias and became more sensitive to legitimate claims and expectations of shareholders. This established the reputation for the Delaware courts as a fair, neutral forum to litigate internal affairs and corporate disputes.

The second historical decision was delivered in 1977 by the US Supreme Court in the case of Santa Fe Industries, Inc. v. Green. In this case, Santa Fe owned 95% shares of a corporation called Kirby Lumber Corp and wanted to own the entire 100%. In order to get the last 5%, they attempted a short form merger to cash out the remaining shareholders as prescribed under the section 253 of the Delaware Corporation Law. Santa Fe offered $150 per share for the remaining shares after a share was valued at $125 by Morgan Stanley as the appraisal.

596 Section 213, Delaware General Corporation Law
598 Jack B. Jacobs, ‘The Uneasy Truce between Law and Equity in Modern Business Enterprise Jurisprudence’ 8 Delaware Law Review
Some minority shareholders, as led by Green, sued to set aside the merger. Rather than pursuing their appraisal remedy in the Delaware Court of Chancery, they brought suit in federal court on the grounds that the merger itself was a violation of Rule 10b-5 because: (1) the appraisal was fraudulent; (2) the merger was accomplished without any corporate purpose and without prior notice to minority shareholders.

The Trial Court dismissed the Rule 10b-5 complaint for failure to state a claim because it did not allege a material misrepresentation or nondisclosure. The Appellate Court agreed that the complaint did not allege a material misrepresentation or nondisclosure, but reversed, holding that neither misrepresentation nor nondisclosure was an essential element of Rule 10b-5 hence any breach of fiduciary duty by a majority of shareholders against the minority could be a violation of Rule 10b-5. The US Supreme Court granted the order of certiorari.

In its final decision, the US Supreme Court held that Rule 10b-5 was only designed to ensure full disclosure and to prohibit conducts involving manipulation and deception. More importantly, the US Supreme Court held that the substantive fairness of fiduciary conduct was predominately a State law concern, not the federal law, because “Congress by § 10 (b) (of the Securities Exchange Act of 1934) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.”

The decision is regarded as a landmark, because it not only reversed outright the creeping federalization of state corporate law in lawsuits brought under Rule 10b-5, but also reallocated to the State courts all litigation challenging the substantive fairness of transactions involving securities including mergers, tender offers, and other transactions touching on corporate control. As a consequence, it “increased the already-strong gravitational pull toward the state judiciary in this area of jurisprudence.”

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602 Jacobs, ‘Fifty Years of Corporate Law Evolution: A Delaware Judge’s Retrospective’ (2015) 5 Harvard Business Law Review 141 See also Marguerite A. Conan, ‘Section 10(b) -- All that is Unfair is not Fraud: Santa Fe Industries, Inc. v. Green’ 19 Boston College Law Review 939
4.4 Original Conditions for Takeover Regulation in the UK?

It has been well established that the institutional investors have been “a catalyst” for law and practice of corporate governance in the UK.603 As a critical area of corporate governance, the takeover market in the UK has also been heavily influenced by the institutional investors. Indeed, “the traditional doctrinal pro-shareholder orientation of British corporate law was reinforced by the rise of institutional shareholding during the precise period that modern takeover regulation was being developed in the UK, i.e., in the 1960s, whereas this coincidence did not occur in the U.S.”604 But the root for the influential institutional investors was planted in a much earlier time.

4.4.1 Rise of Institutional Investors

As Figure 4.1 shows, institutional investors first started to accumulate significant proportions of shares in British companies in the mid-1950s. By the mid-1960s, they were finally established at the heart of UK corporate governance.605

Figure 4.1, Share ownership patterns in the UK, 1957–2004

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The emergence and dominance of institutional investors in British stock market from the 1950s is primarily a consequence of various taxation measures. The post WWII tax scheme is greatly in favour of investment via institutional intermediaries as compared with direct ownership of shares by individuals.  

On the one hand, the punitively high taxation of dividends plays as the key factor in deterring retailed investors from direct investment in share market. As from 1965 onwards, retailed investors have to pay capital gains tax of 30 per cent on their investment income made from the stock market. Even without capital gains tax, an investor generally needed to make a profit of 10 per cent or more on the sale of shares to cover the attendant transaction costs including stamp duty.

One the other hand, tax relief schemes in the same period are largely accorded to collective institutional investments. The most extensive is that granted to pension funds, which are entirely exempted from tax on dividend income. In addition, insurance companies also enjoy a favorably low rate of tax on dividend income. A 1957 survey of income tax in nine industrialized countries suggests that the UK is “probably unequalled in the thoroughness of its reliefs for contributions towards retirement and survivor benefits.”

Together, these factors exerted a pressure away from direct ownership of shares by individuals and towards collective ownership of shares by institutional investors. The consequence is a reallocation of investment priorities by institutional intermediaries and a massive increase in funds available for investment, which leads to the dominance of institutional investors in the British stock market. As the Economist said in a survey of British investment:

*The enormous advantages of institutional saving for the rich who might once have invested in equities but who are now prevented from doing so by tax,*

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606 Ibid  
607 Ibid  
609 Among institutional investors, pension funds and insurance companies were the dominant players, with the percentage of shares owned by both growing from 9 per cent in 1957 to 33 per cent in 1975 and 51 per cent in 1991. Ibid  
610 Ibid
explains the overwhelming dominance the institutions have acquired in the stock market.611

For example, by 1953 pension funds of commercial and industrial companies had 19 per cent of their assets invested in ordinary shares of companies; this figure rose to 30 per cent by 1955 and 48 per cent by 1963. At the same time, given the unfavourable climate for direct investment in shares, private investors not surprisingly turned to forms of savings that received more favourable tax treatment. One example is the large increasing of total financial assets of pension funds: as large as 32 times growth over the same period (£1.3 billion in 1952 and £41.0 billion in 1979).612

Consequently, institutional investors steadily grow to be the predominant investors in the UK stock market from 1950s, when the first wave of hostile takeovers began. The dominant power of the institutional investors has rendered decisive influence not only on the individual result among increasingly heated takeover wave, following which, more importantly on the establishment of the comprehensive self-regulatory system over British takeover market. The following section examines how the institutional investors decisively influenced takeover battles and the creation of the Panel system.

4.4.2 Establishment of the Panel System

As in the US, when the first wave of hostile takeovers in the UK began in the early 1950s, much of the British business community was outraged by the advent of the takeover bid and believed that takeovers were harmful for industry.613 Felt justified in fending off these unsolicited offers, directors referred to various controversial defensive tactics to deter or to frustrate hostile offers. Many of these tactics, nevertheless, are rather controversial as exemplarily illustrated by the 1953 battle for Savoy Hotel Ltd.614

In 1953, Harold Samuel started purchasing shares of Savoy Hotel Ltd. with the intention to convert Savoy’s Berkeley Hotel into commercial offices. The discontented Savoy’s board of directors, without the authorization from the

611 Cited by ibid
612 Ibid
shareholder meeting, unilaterally implemented a “lock-up” strategy. Under this “lock-up” strategy, the Berkeley Hotel was to be sold to a new entity and leased back to the Savoy on terms that the building should be used only as a hotel. Limiting the use of Berkeley Hotel effectively compromises the purpose of the unsolicited bidder.615

The legitimacy of this “lock-up” strategy is highly controversial, because the shareholders of Savoy have been deprived of the decisional power regarding the bid’s outcome. But no precedents or rules exist to render a binding decision as for the legitimacy of conducts of the target board. The Board of Trade, at the request of the bidders, appointed an inspector, Mr. Milner Holland QC, under the section 165 of the Companies Act 1948, to investigate whether the board of the Savoy Hotel had committed any breach of fiduciary duty to the company or its members. Although Mr. Milner Holland QC concluded that the action was invalid, he admitted that he could find no legal authority for his view.616

Another takeover battle happened shortly after. At the end of 1958, the managers of British Aluminum Ltd. (“BA”) were approached by two rival camps: one from the US Reynolds Metal Company in partnership with UK-based Tube Investments (“TI-Reynolds”), and the other from the Aluminum Company of America (“Alcoa”). Without informing their shareholders, BA’s board rejected TI-Reynolds’s approach, instead agreeing to a deal with Alcoa under which the latter was issued with new shares amounting to a one-third stake in BA.

It was only when TI-Reynolds made clear that they intended to go over the BA directors with an offer directly to the shareholders that the BA’s board publicly revealed the Alcoa deal.617 The BA board then tried to “bribe” their shareholders with a generous dividend increase, which boosted the share price considerably. This action only served to confirm the perception that Alcoa had been permitted to buy a large block of shares at the earlier undervalued price. Shareholders’ response was “quick” and “devastating”: they dumped BA stock as fast as TI-Reynolds could buy it.618

615 Battle for the Savoy, Economist, December 12, 1953
617 British Aluminium Reveals Contract with Alcoa, Times (London), November 29, 1958.
The BA board’s conduct provoked widespread calls for takeover regulation. As a response, the Governor of the Bank of England in July 1959 established a working group to devise a code of conduct to regulate takeover bids. The working group comprised of the London Stock Exchange and other trade groups representing institutional investors, investment banks and finance houses.\textsuperscript{619} Neither of the major contemporary management organizations, the Institute of Directors or the Association of British Chambers of Commerce, was involved in the principal deliberations of the code.\textsuperscript{620} In the autumn of 1959, the working group announced the \textit{Notes on Amalgamation of British Businesses}. The \textit{Notes} contained a series of general guidelines that were “concerned primarily to safeguard the interests of shareholders.”\textsuperscript{621}

The effects of the \textit{Notes} were limited due to the lack of mechanisms for adjudication and enforcement. A growing number of “not very edifying squabbles” were observed with the increasing popularity of utilizing hostile takeover bid as a means of acquiring control of public companies. Things come to a head in the late 1960s, when two takeover cases occurred to violate the parity of treatment of all shareholders as required by the then prevailing Notes.

In the first case, directors of both Metal Industries Ltd., (“Mental”) and Thorn Electrical Industries (“Thorn”) intended to effect a merger. A third party, Aberdare Holdings (Aberdare), was desirous of acquiring control of Metal. After a stealthy market purchasing, Aberdare succeeded in acquiring 53 per cent of the outstanding shares of Metal. The discontented directors of Metal decided to issue to the preferred Thorn five million shares. Thus, Aberdare’s share ownership of Metal shrunk from 53 per cent to 32 per cent.

In the second case, two competing bidders, Phillip Morris and American Tobacco, sought control of Gallagher. American Tobacco eventually succeeded by offering a partial bid for half of the Gallagher shares. Its success was attributable to Imperial

\textsuperscript{619} They include the Issuing Houses Association, the Accepting Houses Committee, the Association of Investment Trusts, the British Insurance Association, and the Committee of London Clearing Bankers.

\textsuperscript{620} It seems most likely that this was simply because these were not “City” organizations, and so the Bank of England was unable to approach them informally and in secret.

Tobacco ("Imperial"), an underwriter of an unsuccessful floatation of Gallagher, which had left Imperial a good number of Gallagher shares. Between the two competing bidders, Imperial sold all its shares to American Tobacco at the bid price.

In both cases, the wrongdoers were "unscathed".622 This widespread evasion of the Notes without punishments led to criticism by the financial press that concluded the Notes had become "a dead letter", and that the only hope for a well-functioning takeover market would be a governmental agency with oversight authority, along the lines of the SEC.623

But the British government did not react accordingly. The then Prime Minister Harold Wilson insisted that statutory rules were not the direct answer but suggested that if the City could not effectively refurbish and enforce its own code of conduct then the government would have to "take the task in hand".624 Under such a pressure, the Bank of England shortly reconvened a Working Party to begin drafting a new set of takeover rules. Again, the Working Party was composed of the representatives of the major financial institutions in the City.625

By the end of March 1968 — the year when US lawmakers enacted federal tender offer rules namely the Williams Act — the draft City Code on Take-overs and Mergers was ready. The new Code was very much in the same shareholder-oriented spirit as the earlier Notes, but its form was more specific, and its lack of mechanisms for adjudication and enforcement was resolved with the establishment of a charging body.626

On March 27, 1968, the City Panel on Takeovers and Mergers ("Takeover Panel") was inaugurated as the private body entrusted with the task of adjudicating disputes arising from takeover transactions. It was formed of nine members, who were drawn

from the organizations represented on the Working Party. Shortly after, further measures were taken to ensure the Takeover Panel’s competency in dealing with takeover disputes.

The first measure was to increase its credibility by appointing highly reputed persons as its key personnel. Lord Shawcross, formerly the Attorney-General and the President of the Board of Trade, was appointed as the non-executive Chairman; Ian Fraser, an experienced takeover specialist from S.G. Warburg, was recruited as the full time executive Director-General; and Lord Pearce, formerly a Law Lord, was appointed as the President of the Appeal Committee.

The second, also more important, measure was to enhance sanctions available to the Takeover Panel. As a private body, the Takeover Panel did not possess a direct statutory basis for enforcing the takeover rules. Consequently, it could not enforce the substantive provisions of the Code through such statutory mechanisms as fines, injunctions, or ordering the payment of compensatory damages. To resolve this problem, an informal mechanism called “cold shoudering” was established.627

Under this informal mechanism, the Takeover Panel would issue formal public censures of violators alerting the financial community to the misconduct. Other existing authority or financial institutions in the City would respond accordingly. For examples, the Stock Exchange and the Board of Trade would exercise its power to censure, suspend or expel a censured wrongdoer from the Official List; the banking community or financial intermediaries would refuse to deal with the censured wrongdoer; other trade associations represented in the Working Party would impose internal sanctions upon the censured wrongdoer holding their membership.628 As proclaimed in the Introduction to a 1981 version of the Takeover Code, the Code:

... has not, and does not seek to have, the force of law, but those who wish to take advantage of the facilities of the securities markets in the United Kingdom should conduct themselves in matters relating to take-overs

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628 Further discussion is under supra Section 2.2.1.1 The Predominant Role of the Designated Takeover Panel, Chapter 2.
according to the Code. Those who do not so conduct themselves cannot expect to enjoy those facilities and may find that they are withheld.629

With these measures implemented, the new created Takeover Panel “has been outstanding successful by the standards of 1969”.630 For example, in its first twelve month of operation, it effectively handled some 575 cases.631 Among them, the swift, decisive but even-handed response to Pergamon Press case greatly enhanced Takeover Panel’s reputation as the competent regulators of British takeover market.

In this Pergamon Press case, the Panel firstly insisted on a full disclosure that revealed wrongdoings such as murky accounting practices and insider dealing at Pergamon. As a result of these wrongdoings, Robert Maxwell attained 31 per cent of Pergamon’s shares and the other bidder, American Leasco Data Processing Equipment Corp., failed to gain the control of Pergamon. The Takeover Panel published a pubic censure and the Board of Trade in response conducted an investigation into Pergamon’s misconducts.632

Thus, the UK takeover regulation as featured with a private system composed of the Takeover code and the Takeover Panel, came to their existence in 1960s largely in accordance with the will of the institutional shareholders.

4.4.3 Roles of the UK Courts

By way of contrast to Delaware courts, the UK courts have never played a similarly prominent role in developing rules governing corporate governance and securities markets.633 This difference is even sharper in the context of takeover market, which has long been considered as the most disputable area within corporate governance or securities market. From 1990 to 2005, as one research documented, the UK takeover

630 Christopher Marley, Takeover Panel Sets Standards, Times (London), May 9, 1972
market has only witnessed 2 cases out of the 187 (or 0.1%) hostile takeover bids reached the courts. Meanwhile, during that same period, of the 312 hostile takeover bids of publicly traded target companies announced, 106, (or 33.9%), were litigated in the US.  

Scholars have attributed this difference to the different procedural rules as applied in both jurisdictions. In the US, the procedure rules of Delaware, inter alia, recognize the unique position of the class action mechanism and the contingent fee agreement. As a result, much greater volume of litigation has been brought to US courts. While under the UK procedure rules, class action mechanisms or the contingent fee agreement have long been restricted, if not barred. Consequently, private shareholders are discouraged from bringing law actions to enforce corporate and securities laws.

Apart from this perspective of procedure rules, the lack of judicial contribution to the takeover regulation in the UK could be also explained from the featuring initial conditions of British takeover market. Numerous takeover fights in the 1950s and 1960s might have provided the opportunity for authoritative judicial guidance on appropriate managerial conduct. For example, the battle for the Savoy Hotel in 1953 saw the target management engaged in an egregious example of an asset lock-up defensive strategy, stopping the acquisition attempt in its tracks. Rather than pursuing the matter in the courts, the bidder chose to push for a governmental inquiry, which produced only non-binding guidance (albeit written by a leading company law litigator) on the duties of the target board.

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Further discussion on supra section 2.2.1.2 The Restrictive Role of the UK Courts, Chapter 2.
638 The bidder intended to, upon its successful acquisition, convert the Berkeley Hotel, one of the key assets of the target company, into commercial offices. As a response, the target management arranged for the Berkeley Hotel to be sold and leased back to the target company on terms that required it to be used as a hotel.
639 Further discussion under supra Note 616 and accompanying text.
The newly established Takeover Panel in the late 1960s has quickly proved to be capable of swiftly and pre-emptively dealing with takeover issues. It has consciously advocated and established the principle that the proactive involvement was better than an *ex post* judicial approach.\(^\text{640}\) This proactive approach soon became institutionalized as the Takeover Panel’s characteristic “real time” guidance in takeover cases, which effectively stemmed the flow of litigation to the English courts.\(^\text{641}\) Deprived of cases to adjudicate, the British judiciary has rather less opportunity, especially compared to its counterpart in Delaware, to exercise their roles in defining the takeover regulation system in the UK.

In fact, not until the late 1960s did the British judiciary deliver their first precedents directly concerning takeover defenses.\(^\text{642}\) By this time the legality concerning takeover defenses had largely been rendered moot by the introduction of the Takeover Code, which prohibits target boards from any measure that might hinder takeovers without the approval of target shareholders. Thus, the limited roles of the UK courts in developing the takeover case law have been accommodative of the original conditions as set by the inception of the Takeover Code and the Takeover Panel in the 1960s.

**Conclusion**

To conclude, an enriched interpretation of path dependency on initial conditions with incorporated legal origins theory provides a comprehensive account for the distinct takeover regulation patterns in the US and the UK. The scrutiny in the previous Parts of the thesis has corroborated that the crystallization of sets of distinct original conditions in the early 20\(^{th}\) century have shed determinant influence on the inception of takeover regulations in the US and the UK respectively, hence suggested a very strong form of path dependency linked to initial conditions.


In the US, since the late 19th century, the law and regulations on the banking and insurance sectors have successfully suppressed the rise and growth of institutional investors in the market. This situation is further consolidated by the New Deals in the 1930s. The New Deals had two more far-reaching influences on the takeover regulations. On the one hand, it vested authority over the securities markets in a federal agency, which not only made it more difficult for institutional investors to coordinate, but it directly preempted certain types of self-regulation by market players such as stock exchanges. On the other hand, it established a federal regime primarily focusing on matters like information disclosure and anti-fraud matters. The limited scope of federal regulation left a gap to the States when it comes to issues involving corporate governance. With the proactive initiatives taken by the State policy makers to attract large amount of incorporations within Delaware, the courts of the Delaware State successfully assumed the leading roles in developing takeover rules, when the wave of hostile takeovers appeared in 1960s and eventually peaked in the 1980s.

In the UK, the original conditions are different. The taxation scheme after the WWII has successfully transferred the ownership of the securities market. Institutional investors, owning to the favoring taxation scheme, gradually ascended to the dominant position and became a significant force in British securities market. As a result, when the wave of hostile takeovers started in 1960s, institutional investors were involved at every stage of the takeover regulatory development, from the drafting of the Takeover Code through the creating of Takeover Panel. The efficient and fair enforcement of the Takeover Code by the decisive Takeover Panel consolidated a self-regulatory regime over British takeover markets, which deprived both a judicial intervention and a government intervention.

Chapter 5 will continue this explanatory thread and apply the enriched path dependency theory to unearth the original conditions that have contributed to the current takeover regulation in China.
Appendices

Appendix 4.1: Legal Origin, Institutions, and Outcomes

Source: The Economic Consequences of Legal Origins

Appendix 4.2: The Distribution of Legal Origins

Source: The Economic Consequences of Legal Origins644

644 Ibid
Chapter 5: Original Conditions of Takeover Regulatory Regime in China

Introduction

From a perspective of the path dependency on original conditions, chapter 4 examined the original conditions for the takeover regulations in the US and the UK as set at the turn of 20th century. This chapter will follow the similar methodology to examine the phenomenon of sensitive dependence on original conditions of Chinese takeover regulations.

As will be elaborated later, the pattern of the Chinese takeover regulatory regime is set by the original conditions as crystallized at the early 20th century, the same period of time when the American and British takeover regulations took the root. This is because the contemporary Chinese legal system, where the takeover regime is embedded, only took shape when the dramatic modernising transformation commenced at the turn of 20th century.645

The following sections first examine the characteristics of three main streams of legal origins behind general legal system of contemporary China; then proceed to investigate the original conditions of corporate practice and regulations; the third part will analyse their remaining impacts.

5.1 The Original Conditions of the Contemporary Legal System

In considering the major characteristics of the Chinese takeover regulatory regime and its embedded general legal system, one must be aware of the fact that current Chinese law is a consequence of the infusion of three streams of influences, as set by the legal modernization that commenced at the turn of 20th century. These three streams of influence are: the adopted Western law, the communist ideology, and the traditional

Chinese law. They set the original conditions for the modern Chinese legal system. The following discussion will trace different regulatory strategies of each stream.

5.1.1 Adoption of Western Law

Modern Chinese history started in a special period of late Qing Dynasty, after the defeat by Great Britain in the first Opium War of 1840-1842. From then on, unprecedented internal and external challenges started to challenge the conventional social, political and legal systems. As a response, the government initiated a series of modernization or Westernization initiatives, such as the Self-Strengthening Movement of 1860-1894; or the Hundred Days Reform of 1898.

The Qing Dynasty at the turn of the 20th century started its legal reform process. The legal reform was aimed to achieve two utilitarian and instrumentalist purposes: to respond to Western criticisms on the cruelty of certain provisions in traditional Chinese law; and to pave the way for the transition from traditional law to modern Western law. Additional assurances from the Western powers also propelled the Chinese government to adopt a Western style legal system. The first assurance was to provide technical assistance once the Qing Dynasty prepared to reform its legal system; the second assurance to relinquish extraterritorial rights upon the establishment of a Western style legal system in China.

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648 For a general introduction to the modern Chinese history, Denis Twitchett, John King Fairbank and Paul Jakov Smith, The Cambridge History of China (Cambridge University Press 2009)
649 Internally, a commodity economy had emerged and widespread social unrest occurred, e.g., the Taiping Rebellion of 1851-1864 and the Boxer Rebellion of 1900; externally, China kept suffering from continuous military defeats at the hands of Western powers, especially the humiliation by the Japanese in the Sino-Japanese war of 1895.
650 For detailed studies of political, economic and social conditioning well as reform movements in China in the Late 19th and early 20th Centuries, see Twitchett, Fairbank and Smith, The Cambridge History of China (Cambridge University Press 2009); Meribeth Elliott Cameron, The Reform Movement in China: 1898 - 1912 (Octagon Books 1963); Immanuel C. Y. Hsi, The Rise of Modern China (6 edn, Oxford University Press 2000)
653 The earliest grant of extraterritorial rights made by China to Western was contained in the supplementary treaty of the Treaty of Nanking between Great Britain and the Qing Dynasty, signed in July 1843. Other main Powers which had extraterritorial treaties with China are the United States in July 3, 1844; France in October 24, 1844;
5.1.1.1 Adoption of Western Law Led by Administrative Power

The first initiative of the legal reform is the creation of Law Compilation Commission (LCC) in 1904. The LCC was headed up by Jiaben Shen, the junior deputy Minister for the Ministry of Punishments, and Tingfang Wu, a former ambassador to the US. Its missions were, *inter alia*, to carefully examine and re-edit all Chinese laws then in force; to survey and translate the laws of foreign countries; to bring existing laws into accord with the conditions required as a result of international commercial negotiations; and to ensure that new laws would be commonly applicable to both Chinese and foreigners. 654

Since the creation of LCC, the reform of traditional Chinese law and the adoption of Western law became a “new cause” for the Imperial Court.655 As praised by Tien-Hsi Cheng, a former Chinese judge at the Permanent Court of International Justice (1936 to 1945), the LCC represented the “commencement of a new era” for Chinese law.656 The LCC, upon its establishment, engaged extensively into the revision of the old laws and draft of a variety of new law codes, including: the Criminal Code (1907), the Law of the Organization of the Judiciary (1907), the Codes of Criminal and Civil Procedure (1909), and the Civil Code (1910).

Apart from the LCC, other legal institutions were also established. For instance, in 1906, the Ministry of Justice (MJ) was set up based on the Ministry of Punishment and assumed charge of the judicial administration; also, the Supreme Court (Dailiyuan) (SC) was converted from the Court of Judicial Review (Dalisi) (CJR) and given

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Norway and Sweden in March 20, 1847; Germany in September 2, 1861; Denmark in July 13, 1863; the Netherlands in October 6, 1863; Spain in October 10, 1864; also Belgium, Italy, Austria-Hungary, Peru, Brazil, Portugal, Mexico, Switzerland, and etc. Footnote 42, Shih-Shun Liu, *Extraterritoriality: Its Rise and Its Decline* (Columbia University 1925)

This special treatment was supposed to be changed should satisfactory circumstances be achieved. According to the revised commercial treaty concluded between the Qing Dynasty and the Great Britain in 1902:

Great Britain … will be prepared to relinquish her extra-territorial rights when she is satisfied that the state of the Chinese laws, the arrangements for their administration and other considerations, warrant her in so doing.


655 Jianfu Chen, ‘The Transformation of Chinese Law - From Formal to Substantial’ 37 Hong Kong Law Journal 689

general control over all judicial decisions. The newly created Ministry of Justice and the Supreme Court often consulted with each other and jointly submitted reform proposals and legal opinions to the Imperial Court.

This group of scattered administrative legal institutions, instead of a parliament or a congress, played leading role in the legal reform and rule making process when the foundation of modern Chinese legal system was laid. This feature has penetrated into the takeover regulatory regime as found under current China legal system, where the dominant regulations emanate from administrative authorities, such as the CSRC, the Ministry of Commerce, State-owned Assets Supervision and Administration Commission etc.

5.1.1.2 Adoption of the Codification Style Civil Law System

Along with the establishment of these institutions, a two-stage reforming agenda was taken by the Imperial Court. The first agenda was to amend the existing laws, with a special focus on replacing the cruel corporal punishments that had existed for hundreds of years. Shortly afterwards, for example, corporal penalties such as dismemberment, exposure of the head and desecration of the corpse were suppressed by the Imperial Court in 1905. By 1910 the core statute representing the then existing legal system, the Great Qing Code, had been completely revised and re-promulgated as a “Current Criminal Code” to serve as a transitional criminal code before the promulgation of a new one.

The main task of the second-stage reform, the making of new laws in line with Western standard, was carried out almost simultaneously. As early as the year 1903 an Imperial Edict authorized the preparation of a commercial code, and a few months

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657 The aforementioned Jiaben Shen also served as the first president of the SC.
658 Xiaoqun Xu, *Trial of Modernity: Judicial Reform in Early Twentieth-Century China, 1901-1937* (Stanford University Press 2008)
659 See further discussions in previous chapter 3.
660 One extreme example of these punishments is the so-called dismemberment, or Slow Slicing (Lingchi), which had existed from roughly AD 900 until its final abolition in 1905. See generally: http://en.wikipedia.org/wiki/Slow_slicing.
661 The revision and the abolition of cruel punishments were initiated very swiftly in 1902. The reform of the police and prison systems were also initiated, further studies see: Meijer, *The Introduction of Modern Criminal Law in China* (University Publications of America 1976)
664 Although a new law would only be implemented after a transitional period, ibid
later, the General Principles for Merchants, the Company Law, and the Bankruptcy Law were promulgated; the Law for the Organisation of the Supreme Court was also released in 1906, and the Law for the Organisation of the Courts in 1910. Drafts of a civil code, a civil procedural code, a criminal procedural code, as well as the new criminal code were all completed between 1910 and 1912.

The legal reform of this period, particularly through the endeavours under the second stage drafting new law codes, lay down the ground-breaking basis for a process of Westernisation of Chinese law. It was during this period that the elements of the Western law and practices were fashioned into China for the first time in the country’s history.

This initial stage of Westernization followed an approach to adopt primarily the civil law model instead of the common law model, by learning directly from Japanese law as established after its successful Meiji Restoration. A concentrated study of Japanese law could be observed firstly with the translation of a large number of Codes from Japanese. Meanwhile, hundreds of scholars and students were sent to Japan to study law; a modern law school was even created in Beijing in 1906 staffed with Japanese scholars, such as Dr. Okada Asataro and Dr. Matsuoka Yoshitada. Thus, a pool of students and scholars with a background of the Japanese legal system grew and naturally they became supportive of emulating the Japanese legal system.

665 Further discussion is followed in next section
667 In 1868, following the feudal regime, the modernization of Japan (Meiji Restoration) started. The Meiji reformers were strongly influenced by legal theories that had evolved in Prussia. France also had an influence on certain areas of law. The first modern constitution and basic codes were enacted following Prussian and French models. The Japanese legal system is based on the civil law system. After World War II, the Constitution was replaced, and many other laws were newly enacted or amended. These new laws were heavily influenced by United States through the Allied Occupation. The principle of judicial review was introduced to Japan from the United States. Overall, the Japanese legal system is closer to the European system. But U.S. influence and Japan’s traditional values have modified the system. Rydji Igeta, ‘Reform of Law in the Meiji Restoration’ 35 Acta Asiatica
668 It is difficult to determine the exact number of students studying law in Japan. According to some recent studies it is clear that the overwhelming majority of students who went abroad at the turn of the 20th century went to Japan and a majority of these students studied law there. See Xianyi Zeng (ed) Chinese Legal History (Zhongguo Fazhi Shi) (2 edn, Higher Education Press 2009)
A good example of the profound Japanese influence on the promulgations of laws was the drafting of the Civil Code. In 1907, Dr. Matsuoka Yoshitada was put in charge of drafting the first three parts (General Principles, Obligations, and Rights in rem); while two Chinese scholars Xienwen Zhu and Zhonghe Gao drafted the last two parts (Family and Succession). Therefore, when the first ever draft of China’s civil code came into being in 1911, it was hardly surprising that it followed the Japanese model, and, indirectly, the German model.

The explanations for why the Qing government and legal reformers preferred the civil law model via learning from Japanese law, to the common law model can be attributed to a few important factors.

The first attribute is the fact that Japan had succeeded in reversing extra-territoriality, in becoming a mighty power in the East Asia, and in transforming itself into a modern nation accepted by Western powers. The Japanese achievement persuaded Chinese, from the Qing court to high officials to general intellectuals, to take Japanese law as a copy of Western models. As Renjun Zhang, the head of the then newly established Supreme Court, argued in a memorial dated on June 11 1907, Japan was “the pioneer in East Asia in combining traditional and foreign legal traditions to devise the best legal system” and what Japanese law had accomplished through its legal reform was “sufficient for the Imperial court” to select from and model after.

The similarity of the two countries in historical, ideological, and cultural features was also seen as a further reason for the emulation of the Japanese model. The Japanese language, which had kept Chinese characters as the written language, served as the bridge connecting the Western and the Chinese. At that date Japan had created a

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670 It was never promulgated due to the collapse of the Dynasty. See discussion on this Civil Code at: ibid Douglas Robertson Reynolds, China, 1898-1912: The Xinheng Revolution and Japan (Harvard University Asia Center 1993)
674 Xu, Trial of Modernity: Judicial Reform in Early Twentieth-Century China, 1901-1937 (Stanford University Press 2008)
technical legal Japanese vocabulary, translated a number of textbooks of Europe and produced a large Japanese legal literature. The Chinese could hence find in Japanese, a language closely related to Chinese, of what represented at that time the “most advanced stage of jurisprudence science of the world”.

More fundamentally, the civil law model was based on the principal Roman concept of dual authorities, that of the *pater familias* over its dependents and that of the state over its citizens. On the one hand, the concept of the *pater familias* fitted well into the conventional Chinese interpretation of law and the prevailing social norms. “The unit of Chinese society being the family, reform naturally seeks to preserve this institution and to modernize it as far as possible after the Continental idea.” On the other hand, the concept of state authority over its citizens as inherited from Roman law also fitted well into conventional political practices and the ultimate goals of the legal reform to secure the emperors’ position permanently through ameliorating foreign aggression, and quelling internal disturbance.

In addition, as Roscoe Pound has pointed out, legal materials in Common law are generally “too unsystematic, too bulky, and too scattered, and its technique is too hard to acquire, to make its adoption possible.” This also explains why the Chinese policy-makers, a hundred years later, adopted the English Takeover Code-style Takeover Measures, instead of a system as represented by Delaware case law. Regulators and judges in China are not sophisticated to administer, either then the judge made common law, or now the Delaware-type of takeover law.

### 5.1.1.3 Adoption of Western Law Imprinted with Political Ideologies

The late Qing reforming efforts did not save the Dynasty. A revolution broke out in 1911 and one year later the Qing Government was replaced by the Republic Government. The Republic Government allowed the continued application of the laws

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This also influence the choice of Japanese reformers when they initiated to create a modern legal system in Japan, where they deemed the introduction of English-style foreign law as “a venture beyond hope because of the vast realm of case law.” Wilhelm Röhl, ‘Generalities’ in Wilhelm Röhl (ed), *History of Law in Japan since 1868* (Brill 2005)
passed under the previous regime. It was declared that all imperial laws formerly in force were to remain effective unless they were modified by new laws or were contrary to the principles of the Republic.\footnote{Chen, \textit{Chinese Law: Context and Transformation} (Martinus Nijhoff Publishers 2008) Page 29}

The legal reform efforts of the late Qing dynasty were also continued. The result is by 1935, the Republic Government had brought to fruition the previous work of drafted bills and provisional laws by enacting the so-called Six Codes: the Constitutional Law, the Commercial Law, the Civil Law, the Criminal Law, the Civil Procedure Law and the Criminal Procedure Law.\footnote{Alice Erh-Soon Tay, ‘Law in Communist China - Part 1’ (1969) 6 Sydney Law Review 153}

This continuation of the legal reform also meant the continuation of the westernisation of Chinese law along the lines of the civil law model. When the reform ultimately resulted in the Six Codes, Chinese law was transformed and westernised in “its form, terminology, and notions”.\footnote{Chen, ‘The Transformation of Chinese Law - From Formal to Substantial’ 37 Hong Kong Law Journal 689} The feature was reflected by Dr. John Ching-Hsiung Wu’s comment on the Civil Law:\footnote{Cited by Chen, \textit{Chinese Law: Context and Transformation} (Martinus Nijhoff Publishers 2008) Page 34}

\textit{If the Civil Code is studied carefully from Article 1 to Article 1225, and then compared with the German Civil Code, the Swiss Civil Code and the Swiss Code of Obligations, we will find that ninety-five percent of the provisions have their origin there: they are either copied directly or copied with some changes of expressions from these foreign codes.}

But the continuation of legal reform in this period was subject to political ideologies of the then ruling party, namely, Kuomintang (KMT), or Nationalist Party.\footnote{Pound, ‘Law and Courts in China: Progress in the Administration of Justice’ 34 American Bar Association Journal 273} These ideologies are manifested by the so-called \textit{San Min Zhu Yi} as devised and advocated by the party founding father, Dr. Sun Yatsen. It literally means in English as the Three Principles of the People – Nationalism (Minzu), Democracy (Minquan)\footnote{\textit{Minquan} literally means people’s sovereignty or people’s rights. As Dr. Sun Yatsen mainly referred to the issue of democracy when he was talking about \textit{Minquan}, the term has thus more often been translated as ‘democracy’. Chen, \textit{Chinese Law: Context and Transformation} (Martinus Nijhoff Publishers 2008)} and
People’s Livelihood (Minsheng). 687 These Principles laid down the ideological foundation for the political arrangement and the legal system under the KMT Government. 688

The implementation of the KMT’s political ideologies is realized through the high involvement of the Party in the process of the legislating. The drafting and promulgating of the Civil Code, for example, clearly illustrates this practice. 689 Drafting members of the Civil Law Codification Commission first formulated fundamental points of bills in the form of “Preliminary Questions of Law” for the national legislature – the Legislative Yuan, which submitted them to the the Legal Department of the Central KMT Political Council for thorough examination.

The Legal Department afterwards returned the examined questions to the Central KMT Political Council with a Statement of Opinions, in respect of whether the bills are complying with the requirements of San Min Zhu Yi. If the Political Council decided to give the approval of the bills based on the Statement of Opinions, it would present them for approval to the Central Executive Committee of the KMT, the highest authority of KMT, before they were submitted to the National Government for adoption and promulgation as required by legislative procedures. 690

5.1.2 Practice of Communist Legal Construction

The legal construction of China’s Communist Party (CCP) did not begin with the establishment of national communist government in 1949. Rather, it started with the pre-1949 local communist regime within its controlled border (local experience or border experience). 691 The local experience set the foundation for the following legal

688 See the Preamble of the Organic Law of the National Government of China (October 4, 1928); the Preamble of the Provisional Constitution of the Republic of China for the Period of Political Tutelage (June 1, 1931), and Article I of the Constitution of the Republic of China (December 25, 1946). Chen, Chinese Law: Context and Transformation (Martinus Nijhoff Publishers 2008)
689 Ibid
development and offered significant clues to the communist characters of contemporary legal system.  

For example, Biwu Dong (1886-1975), a principal member of the first-generation CCP leadership in charge of legal work and the first President of the Supreme People’s Court, in his speech to the Eighth National Congress of the CCP explicitly acknowledged that the establishment of the PRC’s legal system was based on the experience of revolutionary justice before 1949.

The following sections examine the features of the communist legal construction before 1949 and the tumultuous legal development of the first three decades after the establishment the national communist government in 1949.

5.1.2.1 Legal Construction of Local Communist Governments before 1949

The CCP was found in 1921, but the Communist legal construction was firstly institutionalised by the Soviet Republic (1931-1934) in Jiangxi Province. In November of 1931, the first ever communist constitutional document, the *Constitutional Program of the Chinese Soviet Republic*, was adopted by the first National Congress of Soviets. The constitutional document represented an “overpowering” Soviet influence. It was largely a copy of the 1918 Constitution of the Soviet Federated Socialist Republics. As Hazard has pointed out, the 1931 *Constitutional Program* was a product of a “Moscow derived formula through the Russian returned students”.

The Communist legal construction in the later period was taking an even more definite shape with a communist style. For example, public trials were commonly employed as a form of propaganda across the regions under the CCP; the judicial committees, comprised of both CCP and government personnel, started operating

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694 Dong is praised by the Communist Part as one the key persons who have “laid the foundation for China's socialist legal system.” CPC Encyclopedia, ‘Dong Biwu, CPC Member Who Took Part in Revolution of 1911’ (http://cpchina.chinadaily.com.cn/2011-10/09/content_13919315.htm) accessed December 01, 2015
695 Ibid
within all levels of the court, which welded together political, administrative and judicial interests.696

In brief, although the pre-1949 communist legal construction were largely experimental and localised in nature, features of the Soviet influence and the early Communist practice, such as the politicisation of law, the popularisation of justice, and the non-independent judicial system, have been institutionalized.697 The Marxist perception of the law as a tool to enforce party policy, to suppress class enemies, and to remould the society, was taking root.698

5.1.2.2 Legal Construction of the Central Communist Government after 1949

In 1949, the national communist government was established, replacing the Nationalist Government in Mainland.699 It marked the end of China’s first period of legal reform and the beginning of a new and more intriguing era.

Similar to the two-step legal reform undertaken by the late Qing dynasty, the “revolution” of the legal system upon the establishment of the Communist Government also featured a two-stage process: firstly, the abolishment of the existing legal system – the so-called bourgeois legal system maturing under the Nationalist Government; secondly, the adoption of a new legal system – the communist legal system following the Soviet Union model.700

The explanation as to why the KMT laws should be abolished was stated in the Directive of the Central Committee of the CCP to Abolish the Kuomintang Six Codes and to Define the Judicial Principles for the Liberated Areas, issued in February 1949. According to the second article of the Directive:701

> Law, like the State, is a tool for the protection of the interests of certain ruling classes...Thus all Kuomintang laws are nothing but instruments

696 These represented an interesting blend of revolutionary Marxist and popular traditional Chinese attitudes, which laid down the feature of the dependent judiciary branch in its following development. Tay, ‘Law in Communist China - Part 1’ (1969) 6 Sydney Law Review 153
699 The replaced ruling party – KMT had maintained its ruling position in Taiwan except 2000-2008, when the Democratic Progressive Party took the control for two terms.
designed to protect the reactionary rule of the landlords, the compradors, the bureaucrats, and the bourgeoisie, and weapons to suppress and coerce the vast masses of the people.

The abolition of the KMT legal system virtually left a legal vacuum. But the urgency to fill the vacuum was not felt by the Government in the first few years upon the establishment of PRC. One reason was that the first few years after the 1949 were still a period for the new central communist government to consolidate its newly gained political control over the country through continuous political and social campaigns. Another reason was that, as many CCP leaders emphasized, the law was nothing but “an extension of military force” subordinate to politics, and judicial functions were equivalent to those of the army and the police. Article 5 of the Directive instructed how the judiciary branch should carry out its adjudication:

Before the new laws have been systematically promulgated, peoples’ judicial work shall be based on policies of the Communist Party and various fundamental principles, laws, decrees, resolutions issued by the People’s Government and the Peoples’ Liberation Army.

It is therefore not surprising that during the first three years upon the establishment of the PRC only a handful of laws were issued, which were urgently required for the political transformation of the society and for consolidation of political powers. Nevertheless, towards the end of 1952 when the power consolidation had been achieved, the Party started shifting its focus towards normal economic development and formal legal construction. Shaoqi Liu, the then President of the State, in his Report to the Eighth National Congress of the CCP in 1956, suggested the systematic construction of formal legal system as one of the urgent tasks of the State:

During the period of revolutionary war and in the early days after the liberation of the country...the only expedient thing to do was to draw up some

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702 For a discussion of these political campaigns, see generally Bill Brugger, *China: Liberation and Transformation 1942-1962* (Croom Helm 1981).
temporary laws in the nature of general principles in accordance with the policy of the Party and the People’s Government ... Such laws in the form of general principles were thus suited to the needs of the time.

Now, however, the period of revolutionary storm and stress is past, new relations of production have been set up, and the aim of our struggle is changed into one of safeguarding the successful development of the productive forces of society ... a complete legal system has become an absolute necessity.

The then President of the Supreme People’s Court, Biwu Dong, also made similar comments in his speech to the same Congress. He pointed out that:706

The problem today is that we still lack several urgently-needed, fairly complete basic statutes such as a criminal code, a civil code, procedural laws, a labour law, a law governing the use of land and the like.

This began the second stage of the legal transformation to build a socialistic legal system. In contrast to the late Qing reformers who turned to Japanese law and Western legal system, the then Communist leaders turn to the Soviet Union model. There are several reasons.

First, it was an ideology taboo for the then Communist leaders to appeal to the Western capitalist legal system. Second, the early legal construction under the local communist government had been greatly influenced by the Soviet model. Third, the Soviet Union had accumulated a pool of knowledge and experience in developing socialist theory of law, promulgating socialist legal codes, administering socialist judicial system. Furthermore, the Soviet Union, by 1950s, had been transformed into a first-rate industrial and military power from a backward agrarian and feudal society.707

Therefore, it became a state policy to transplant legal theories and institutions from the Soviet Union to the “New China”. Similar to what happened between China and Japan during the late Qing Dynasty reform, many Chinese scholars were sent to the

Soviet Union; many Soviet scholars were also invited to China to help with the “socialist legal construction”. A large number of Soviet law textbooks and codes were translated into Chinese. For example, by 1957 there had been more than forty Soviet textbooks and monographs in the civil law area alone translated and published in China.\textsuperscript{708}

Following these efforts, the PRC Government in 1954 adopted the first national Constitution, also the Organic Law for Courts and the Organic Law for Procurators. At the same time, drafting work of other basic laws, including the civil code and the criminal code, were also under way. The direct influence of the legal system of the Soviet Union was apparent in most of these works, all of which were to become the foundation upon which the contemporary legal system is founded.\textsuperscript{709}

Unfortunately, the second stage of the effort to establish a new communist legal system following the Soviet Union model was abruptly ended by what latter termed “leftist errors” or a “communist wind”, i.e. the Anti-rightist Movement of 1957 and the Great Leap Forward of 1958.\textsuperscript{710} The political climate further deteriorated after 1958, since when the main leaders, especially the Chairman Mao and the Prime Minister Enlai Zhou, started opposing legal constraints on the Party and the Government’s endeavours to construct a communist society.\textsuperscript{711} For example, Premier Enlai Zhou said in a speech made on 16 September 1958 that:\textsuperscript{712}

\begin{quote}
Why should we proletarians be restrained by laws?!...Since 1954, emphasis has been put on standardisation and legal institutionalisation of plans through law. This in fact is regularisation. We wrote a large number of regulations and rules that then hindered our development.
\end{quote}

With the inception of other political movements, such as “Four Cleaning-ups Movement” of 1963-1965 and the Cultural Revolution of 1966-1976, the entire social, political, and legal system collapsed. State law and regulations were replaced by party policies or even by personal pronouncements.\textsuperscript{713} This chaotic period was only

\begin{itemize}
\item \textsuperscript{708} Chen, ‘The Transformation of Chinese Law - From Formal to Substantial’ 37 Hong Kong Law Journal 689
\item \textsuperscript{709} All together 4,072 individual laws, regulations and decrees were pawed from October 1949 to October 1957.
\item \textsuperscript{710} Brugger, \textit{China: Liberation and Transformation 1942-1962} (Croom Helm 1981)
\item \textsuperscript{711} Tay, ‘Smash Permanent Rules: China as a Model for the Future’ (1976) 7 Sydney Law Review 400
\item \textsuperscript{712} Quoted in Chen, \textit{Chinese Law: Context and Transformation} (Martinus Nijhoff Publishers 2008)
\item \textsuperscript{713} Tay, ‘Smash Permanent Rules: China as a Model for the Future’ (1976) 7 Sydney Law Review 400
\end{itemize}
changed a decade later when the economic reform and the opening-up policy were resumed in 1978.\textsuperscript{714}

In short, the communist legal practice, both before 1949 and after 1949, consolidated the Communist ideology and its early experience into the PRC’s legal system. In the limited period when rules and regulations were enacted and applied, they were at the most deemed as instruments to implement party policies. Indeed, under a regime featuring a planned economy and a state-controlled society, it could be rather difficult to find the separation between law and politics: law is to serve political ends.\textsuperscript{715}

5.1.3 Traditional Law and Philosophy

It is true that both the ancient positive law and traditional legal philosophy have been out of fashion since the turn of the 20\textsuperscript{th} century upon the commencement of modernization process. But the breakdown of the traditional legal system does not necessarily mean the total disappearance of the influence of traditional Chinese law.

Just as Maitland points out in his discussion on \textit{The Forms of Action at Common Law}, “The forms of action we have buried, but they still rule us from their graves.”\textsuperscript{716} Certain fundamental features of the traditional Chinese law clearly have persisted in the contemporary legal system and are reflected by the regulatory regime over takeover transactions.\textsuperscript{717} The past “lives on in China, muted and transformed in certain ways, vital and persistent in others”.\textsuperscript{718}

Indeed, the instrumentalist and utilitarian approach to legal modernization,\textsuperscript{719} both under the Qing and the KMT, reflected the influence of the traditional conception of law as an instrument for the authoritarian State, with its focus on State interests as defined by the State itself.\textsuperscript{720} The following sections will examine the features of ancient Chinese law from both perspectives of positive law and legal philosophy.

\textsuperscript{714}The economic reform and the accompanying legal development will be the theme of Chapter 7.
\textsuperscript{715}In particular, law is to be used by the proletariat as a weapon in class struggles against the enemy in order to realize the people’s democratic dictatorship. Peerenboom, \textit{China’s Long March Toward Rule of Law} (Cambridge University Press 2002).
\textsuperscript{716}Frederic William Maitland, \textit{The Forms of Action at Common Law} (Cambridge University Press 1954)
\textsuperscript{717}Elaborated in following sections.
\textsuperscript{719}Further discussed under the infra section 5.3
\textsuperscript{720}See further discussions on the following section 5.2 about the early development of corporation and its regulations
5.1.3.1 Features of the Ancient Positive Law

Ancient China has presented itself with a long legal history and rich legal resources. As Wigmore praised: the Chinese legal system is “the only one that has survived continuously to date—a period of more than 4000 years; in comparison, the other living systems of today are but children.”\(^{721}\) Indeed, the number of formal Chinese laws is, as Bodde and Morris puts it, “large in quantity, fairly readily available, and covers a longer time span than that of any other present-day political entity”.\(^{722}\)

For example, the “Book of Punishments” (Xingshu), which was inscribed on a set of bronze tripod vessels in 536 BC, has been well established as the earliest published law code in Chinese history.\(^{723}\) A remarkable long sequence of very elaborate and systematic Dynastic Codes could be also traced from the Code of Tang Dynasty as compiled by 653 A.D. with 502 articles in total, to the Code of Qing Dynasty as compiled in its definitive form by 1740 A.D, arranged in 436 sections.

As a strategy of “social control”,\(^{724}\) the ancient positive law was “operating in a vertical direction, and used as a supplementary means for maintaining a hierarchical social relationship that continued for centuries.”\(^{725}\) The Code of Qing Dynasty could be a very good example of this feature. The Code served as the fundamental law dealing with virtually all aspects of the social life, including marriage, divorce, inheritance, debt etc. All these matters were dealt with in the form of criminal penalty from the main consideration of State interest.\(^{726}\) As William Jones suggests: “the Great Qing Code looked at society from the point of view of the central government…it is concerned on how actions affect the operation of the State.”\(^{727}\)

\(^{722}\) Derk Bodde and Clarence Morris, Law in Imperial China (Harvard University Press 1967)
\(^{724}\) Porta, Lopez-de-Silanes and Shleifer, ‘The Economic Consequences of Legal Origins’ (2008) 46 Journal of Economic Literature 285
\(^{725}\) Chen, ‘The Transformation of Chinese Law - From Formal to Substantial’ 37 Hong Kong Law Journal 689
Turning to the enforcement of these Codes, the idea of active judicial independence was never a part of the traditional legal system.\textsuperscript{728} The local governors bore responsibilities covering adjudication and other aspects of governance within their territorial jurisdiction.\textsuperscript{729} Moreover, adjudication by local governors usually included proposing resolutions to their superiors, who decided whether to approve or reject those proposals. In essence, they are the “means through which the Emperor governed at the lowest level.”\textsuperscript{730}

5.1.3.2 Features of the Traditional Legal Philosophy

Traditional Chinese law has been significantly influenced by two schools of philosophy, namely, the Confucianism and the Legalism.\textsuperscript{731}

Confucianism to Demoralize Litigations

The Confucianism emphasizes \textit{lizhi}, or a society governed by \textit{li}, which could be literally translated as morality, virtue, rites or rituals, or propriety, or the combination of all of them. The focus of the Confucianism is more on the interests and harmony of the family, clan, or community than the rights of a single person. The lofty goal of the Confucianism is to achieve a harmonious social order by prescribing different types of behavioural norms in accordance with a person’s status as defined in the various forms of social relationships.\textsuperscript{732}

The Confucianism believed that it would be more advisable to correct improper social behaviours and to uphold the normal social order by means of moral education and by the cultivation of ceremony and etiquette, rather than by laws or punishments. In one of his most cited passages, Confucius (551 – 479 BC) said:\textsuperscript{733}

\textit{If the people be led by laws, and uniformity sought to be given them by punishments, they will try to avoid the punishment, but have no sense of...}


\textsuperscript{729} A local governor was the judge, the tax collector and the general administrator. He was charge of the postal service, salt administration, police, public works, granaries, social welfare, education, and religious ceremonial functions. Local governors were also responsible for defending their city in the event of an uprising or foreign invasion.


\textsuperscript{731} For a summary of Chinese philosophy, Yu-Lan Fung, \textit{A Short History of Chinese Philosophy} (Free Press 1997)

\textsuperscript{732} Tongzhu Qu, \textit{Law and Society in Traditional China} (Hyperion Press 1980)

\textsuperscript{733} Confucius, \textit{Confucian Analects}, vol II, Wei Chang (James Legge tr, 500 BC)
shame; if they be led by virtue, and uniformity sought to be given them by the rules of propriety, they will have the sense of shame, and will organize themselves harmoniously according to the proper rules of conduct.

Therefore, in the doctrine of Confucianism, law was the strategy of social control inferior to moral education. Confucianism has no great regard for the function of the law; much less could Confucianism encourage establishing legal rights and maintaining social order through litigation. The ethics of Confucianism appeal to a citizen to seek a compromised resolution by mediation rather than adjudication if a wrongdoing occurs. Anyone calling in a state authority to put a fellow-citizen publicly in the wrong was regarded as a disruptive, boorish, and uncultivated person vis-a-vis social tranquillity, hence lacked the cardinal virtues of modesty and readiness to compromise.\footnote{Zweigert, Kotz and Weir, An Introduction to Comparative Law (Clarendon Press 1998)}

It is an ideal goal to minimize the application of law and the adjudication of disputes in the society. “In hearing litigation,” Confucius once proclaimed when he was serving as the chief judicial officer for the then Lu Kingdom (1042 – 256 BC): “I am much the same as any other judge. If you insist on a difference, it is perhaps that I try to get the parties not to resort to litigation.”\footnote{Confucius, Confucian Analects, vol XIII, Yen Yûn (James Legge tr, 500 BC)}

**Legalism to Uphold State Control**

The other influential traditional philosophy is the Legalism, also called the Legal Realism. The Legalism asserted that the governance of a society depended primarily upon the rewards that encouraged good behaviours and the punishments that discouraged bad behaviours. A strict, clear, and public legal code was deemed by the Legalism as an effective means to secure the social order, and to strengthen the State control over the families or the clans.\footnote{Wang, ‘China: Legal Reform in an Emerging Socialist Market Economy’ in Ann Black (ed), Law and Legal Institutions of Asia: Traditions, Adaptations and Innovations (Cambridge University Press 2011)}

\footnote{Qu, Law and Society in Traditional China (Hyperion Press 1980)}
Hence, to Legalists, a promulgated law is essential for maintaining the social and political order. Lord Shang Yang (395 –338 BC), one of the key founders of the Legalism and the Premier of the then Qin Kingdom (900–221 BC), once declared: 737

*Law is the authoritative force of the people, and the key of governing... a wise ruler must signify the rule by law, so to speak, and act according to the laws that the country would expand, the army would be strong, and the ruler would be venerated. Rule by law is fundamental to governance.*

The Qin Kingdom following the principles of Legalism, and later when it became the Qin Empire in 221 BC, the first dynasty to unite China, the Legalism was officially adopted as the predominant strategy of social control for the State. The Qin Empire was a short existence. Two decades later it was replaced by the Han Dynasty in 206 BC.

The succeeding Han Dynasty did not adhere to the doctrines of Legalism. Under the Emperor Wu (140–87 BC), instead, the Confucianism was elevated as the orthodox doctrine of the State, the spiritual and philosophical basis for the society. The consequence is what later called as the “Confucianisation of the Legalist Positive Law”, meaning the incorporation of the spirits of Confucian teaching into the enactment and the enforcement of the positive law. 738

This significant reincarnation of the Confucian doctrine was well illustrated, for example, by one of the guiding adjudicating protocols, namely, *Chun Qiu Jue Yu*, which mandated the adjudication following principles developed under the book Chun Qiu, one of the Confucian classics. The introduction of this protocol demonstrated the penetration of Confucian teaching into the enforcement of the positive law and the superior status of the Confucian philosophy over the Legalian as the leading ideology.

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738 That is, it constituted a set of moral values that the state sought, through both persuasion and coercion, to inculcate in the people. This does not mean that Confucianism enjoyed constant and uniform success or that it underwent no changes. Some emperors were swayed more by Buddhist or Taoist beliefs than Confucian, especially in the centuries between the collapse of the Han and the beginning of the Sung. Geoffrey MacCormack, *The Spirit of Traditional Chinese Law* (University of Georgia Press 1996); Wang, ‘China: Legal Reform in an Emerging Socialist Market Economy’ in Ann Black (ed), *Law and Legal Institutions of Asia: Traditions, Adaptations and Innovations* (Cambridge University Press 2011)
That is why the law of imperial China has been described as being legalist in form and predominantly Confucian in spirit.\textsuperscript{739}

Overall, the law in ancient China was designed in practice and perceived in theory as an instrument for the benefit of reigning dynasties to govern and control the people and the society, rather than as an instrument for the society and the people in general to define and defend their rights or freedom. An appreciation of these features provides us a better understanding of how the Chinese people view the role of law in Chinese society and the legal institutions that develop, implement, and enforce the law in China.

### 5.2 Original Conditions of Corporate Regulations

The origin of the corporate organisation, operation, and regulation in China is a matter of adoption and adaptation from the Western countries as China’s modernisation commenced at the turn of 20\textsuperscript{th} century.

On the one hand, the official policy since the Han dynasty (206 BC–24 AD) has been to promote agriculture and to restrict commercial trades.\textsuperscript{740} As a result, although business organisations such as the lineage trust or the partnership appeared as early as in the Spring and Autumn Period (770–476 BC) and became highly developed to a certain degree akin to the *Commenda* and *Societas* in the Ming and Qing Dynasties (1368–1911 AD), they have never evolved into a business form resembling the modern company.\textsuperscript{741}

On the other hand, traditional Chinese law had presented a unique style of social and economic control. Civil or commercial disputes were considered as “trivial matters” by the State and treated with criminal sanctions as stipulated under Dynastic Codes. The consequence was that a formal civil/commercial law, as a separate field, simply did not come into existence.\textsuperscript{742}

\textsuperscript{739} MacCormack, *The Spirit of Traditional Chinese Law* (University of Georgia Press 1996)
\textsuperscript{740} For example, business was heavily taxed. The law provided severe punishments on breaches in the course of business transactions. Also sea trade was forbidden many times. Yuwa Wei, ‘The Historical Development of the Corporation and Corporate Law in China’ (2002) 14 Australian Journal of Corporate Law 240
\textsuperscript{741} Ibid
\textsuperscript{742} The absence of a formal and comprehensive law did not mean that there were no systems for resolving disputes relating to commerce. Dispute resolution by guild, lineage, or local notables, based on the detailed regulations of guilds and families as well as on longstanding custom, was rather commonplace. William C. Kirby, ‘China
This section will first examine the developmental features of the early practice of the company as a business institution and the roles of the then governments. It will then examine the features of the first Chinese Companies Act, namely the 1904 Companies Act, and its influence on the following development of business structures and corporate rules. Features of corporate regulations in the following decades and its remaining influence on the current corporate governance and takeover regime are also examined.

5.2.1 Government Involvement in the Early Practice of Corporate Operation

Although the Chinese word for “company, or corporation” – 公司 (gōng sī) – appeared as early as in 1687, it was only after 1840s that the word was used to refer to a particular form of business organisation. With the increasing interaction with the Western companies, a result of the treaty signed after the First Opium War between China and the UK, the Qing Government gradually recognized the values of companies as a form of the business institution to facilitate the national economy development. In the so called “Self-Strengthening Movement” (1861-1895), the Government campaigned for the adoption of Western style companies to replace the conventional “lineage trusts and partnerships” and created the first group of “modern corporations” in China.

These newly born Chinese companies could be divided into three categories: (1) companies owned and managed by the government; (2) companies owned by merchants but managed by the government; and (3) companies jointly owned and managed by the government and merchants. Obviously, these companies were not

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745 The Self-Strengthening Movement, set to improve Chinese economic, military and political power, mainly focused on the military and heavy industries, such as, the transportation (shipping and railways), the communications (telegraph), and mining, etc. see Chenxia Shi, ‘Commercial Development and Regulation in Late Imperial China: An Historical Review’ (2005) 35 Hong Kong Law Journal 481
modern companies in a strict sense. The paradigm of government-business relations with the visible hand of the State, as further discussed in the following sections, has been inherited by SOEs under the following regimes including the Nationalist government and Communist China.

The peculiar ownership and managerial arrangements with the governmental involvement resulted in various issues within the newly born companies. For example, the protection of private capital investment was lacking and embezzlement of private capital by government officials was common practice. Because the government could directly interfere in literally every matter of the management of these companies such as the appointment of directors and executives; the government could unilaterally dispose of the assets of the companies; while other private investors basically exercised no shareholders’ rights apart from their right to dividends.

5.2.2 The First Companies Act of 1904

The experience of the early corporate practice enabled and encouraged the then Qing Government to enact a legal framework to promote the organization and the operation of commercial corporations in China. In the April of 1903, the Qing Government ordered Zai Zhen, a Manchu prince; Shikai Yuan, the then most powerful Chinese Governor-General of the realm and later the first formal President of the Republic Government (1912-1915); and Dr. Tingfang Wu, the former Chinese ambassador to the US, together with the Law Codification Commission to compile a commercial code. In January of 1904, the first ever comprehensive Companies Act in Chinese legal history was officially published.

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748 Shi, ‘Commercial Development and Regulation in Late Imperial China: An Historical Review’ (2005) 35 Hong Kong Law Journal 481
750 For example, in 1885, the Qing Government took away the reserve fund 100,000 taels from Zhaoshangju, a merchant owned and government managed company. In 1896, the government took away another 800,000 taels from the company. Wei, ‘The Historical Development of the Corporation and Corporate Law in China’ (2002) 14 Australian Journal of Corporate Law 240
751 It should be acknowledged that at least in terms of legal chronology, China was not far behind the Western countries or Japan regarding the introduction of the corporate law system. Internationally, the French Code de Commerce in 1807 had been the first to recognize a general legal right to form a corporation as a juristic person
In promulgating the 1904 Companies Act, the Qing Government attempted to achieve several interlocking objectives. The first objective was to restore the judicial sovereignty. It aimed to attain a modern legal system according to the perceived Western standards by which to justify the government appeal for the abolition of extraterritorial jurisdiction. The extraterritorial jurisdiction, which had restricted China’s judicial sovereignty since the 1840s, had been defended with the Western belief that Chinese law was barbaric. As proclaimed by Great Britain in the Sino-British Treaty of Commerce of 1902, Britain was willing to relinquish its extraterritorial privileges “when Britain is satisfied that the state of Chinese laws and the arrangement for their administration warrant Britain doing so”.

The second objective was to promote China’s industrial development and to compete against the foreigners. It was submitted that: “… America and some European countries have the most detailed and explicit corporate legislation and their governments are keen to support their corporate activities. This leads to the prosperity of their economies…China has conventionally underestimated commerce and neglected commercial legislation…If the government does not deal with the matter immediately, Chinese merchants will never be able to compete with foreign merchants. China must have commercial law.”

The second goal of the 1904 Companies Act, therefore, was to provide Chinese businessmen with a set of corporate laws to promote the creation of Chinese companies to compete with the foreigners.

The achievement of these objectives also served indirectly for a third objective: to strengthen the power of the central government. The governmental policy to advance commercial activities and promote industrial development did not mean that the Qing
Government became pro-capitalism; it is rather by defining and regulating processes of economic change did the throne hope to strengthen ties between central authority and economic elites.\textsuperscript{755}

The 1904 Companies Act was based on the UK Companies Acts of 1855, 1862, and Japanese Commercial Codes of 1890, 1899. It has been found that 60 articles out of the 131 of the 1904 Companies Act had roots in the Commercial Code of Japan, while 30 articles had roots in the UK Companies Acts; the remaining were either well-recognized general principles, or similar to rules from Commercial codes of Germany or France.\textsuperscript{756} Another comparative research suggests a similar conclusion that three fifths of the Companies Act were modelled after Japan; while two fifths was from the UK.\textsuperscript{757}

Hence the 1904 Companies Act was a hybrid result of the civil law system and the common law system, while the civil law system had major influence. It started a legislative approach via the transplantation, which has persisted and manifested itself by the following corporate law evolution. For example, experience was drawn from the law and practice in many jurisdictions for the promulgation of Companies Act 1993 and its revisions.\textsuperscript{758}

The introduction of the 1904 Companies Act was the first systematic initiative of the government to institutionalized commercial activities in China according to the Western model.\textsuperscript{759} It contained fundamental principles of modern corporate practices. New institutions such as the board of directors, the shareholders meeting, the legal

\textsuperscript{755} Ibid
\textsuperscript{756} Lizhi Xu, ‘A Study on Foreign Legal Transplantation into 1904 Company Act (Luelun Daqing Shanlv Dui Waiguo Fa De Yizhi)’ 38 Journal of Zhengzhou University (Philosophy and Social Science Edition)
\textsuperscript{757} Qinghua He and Xiuqing Li, \textit{Foreign Law and Chinese Law - A Reflection on the Transplantation of Foreign Law into China in the 20th Century} (Waiguo Fa Yu Zhongguo Fa - Ershi Shiji Zhongguo Yizhi Waiguo Fa Fansi) (China University of Political Science and Law Press 2002)
\textsuperscript{758} Further elaboration under infra chapter 7, see generally, Liu Junhai, ‘Experience of Internationalization of Chinese Corporate Law and Corporate Governance: How to Make the Hybrid of Civil Law and Common Law Work?’ 26 European Business Law Review 107
personality, the limited liability, and so on, were formally introduced into Chinese business practice for the first time.\footnote{Wei, ‘The Historical Development of the Corporation and Corporate Law in China’ (2002) 14 Australian Journal of Corporate Law 240}

The 1904 Companies Act, however, failed to effectively transform Chinese business organizations into “full-blown corporate institutions”.\footnote{Shi, ‘Commercial Development and Regulation in Late Imperial China: An Historical Review’ (2005) 35 Hong Kong Law Journal 481} The 1904 Companies Act fell short on at least three counts.\footnote{There were some other problems, such as the badly translation from other nations’ experience caused vague and ambiguous provisions, which further engendered distrust among the industrial sector. Wei, ‘The Historical Development of the Corporation and Corporate Law in China’ (2002) 14 Australian Journal of Corporate Law 240; Koll and Goetzmann, ‘The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control’ in Morck (ed), A History of Corporate Governance around the World: Family Business Groups to Professional Managers (University of Chicago Press 2007)} Firstly, despite the fact that the new law vigorously attempted to assert shareholder rights, it failed to sufficiently shift the control of companies from managers, previously empowered by government patronage, to shareholders. There absented clear divisions of the power and rights between the board of directors and of the meeting of shareholders.\footnote{Ibid}

The new legal status of incorporation did not lead to a significant improvement with regard to curbing the intervention by the Government or protecting the interests of private shareholders. The line of hierarchy with a company remained mostly unchanged.\footnote{David Faure, China and Capitalism: A History of Business Enterprise in Modern China (Hong Kong University Press 2006) Page 53} As David Faure notes, “tradition-bound attitudes were not replaced by shareholding in the modern companies. Rather, it was shareholding that was being absorbed into the Chinese business tradition”.\footnote{Shi, ‘Commercial Development and Regulation in Late Imperial China: An Historical Review’ (2005) 35 Hong Kong Law Journal 481}

Secondly, the Companies Act failed to effectively stimulate the emergence of a robust securities market that would induce founders of family-owned firms or their entrepreneurial managers to exchange the corporate control for access to shareholder capital. The conventionally deep-rooted family patrimonial concept resulted in a situation where the establishment and operation of the company was often limited to the joint venture of a close circle based on kinship.\footnote{Shi, ‘Commercial Development and Regulation in Late Imperial China: An Historical Review’ (2005) 35 Hong Kong Law Journal 481} The top-down approach to create a robust corporate sector overlooked the role of the capital market as an
important disciplinary and institution motivational for separation between the ownership and the management.\textsuperscript{767}

Thirdly, the weak institutional foundation constrained the enforcement of the new Act. There are at least two main institutional mechanisms to enforce corporate rules. The first mechanism is to have an independent regulatory body such as the SEC in the US that administers rules involving appropriate public reporting, accounting and much else. A strong independent regulatory agency was barely conceivable in the first decades of the 20\textsuperscript{th} century in China.\textsuperscript{768}

The second mechanism is to have an independent and competent judicial system, which, by no means, functioned in the China of 1904. Not only had judicial decisions been subject to the intervention of powerful politicians or military figures, but also the court system was incompetent to handle sophisticated corporate disputes.

As a consequence, corporate disputes were referred to an administrative entity, the newly formed Ministry of Commerce, which was the very authority promulgating and publishing the Companies Act. This scenario has been inherited by the current takeover regulatory regime in China, within which the judiciary power is impotent while an administrative authority dominates in the development and enforcement of takeover rules.

### 5.2.3 Corporate Practice and Regulations with Continued State Intervention

In 1927, the Nationalist Party, also called Kuomintang (KMT), took over the central government of China. The founding father of the Nationalist Party and the Nationalist Government, Dr. Sun Yatsen, pointed out that the industries concerning the people’s livelihood and the national economy were not to be controlled by private capital.\textsuperscript{769} The Nationalist Government hence posit itself as an intrusive central government with the ambitions of the State control of economic development.

\begin{footnotesize}

\textsuperscript{768} Central governments at that time had little capacity to do much of anything other than to mobilize an army to fight the government’s political opponents. Ibid

\textsuperscript{769} Dr. Sun Yatsen, ‘The Speech at the Farewell Party for the Members of Tongmeng Society’ in \textit{Complete Works of Dr Sun Yatsen}, vol 2 (Zhonghua Book Company 1982)
\end{footnotesize}
The Nationalist Government took a more immediately instrumental view: utilizing law as one vehicle mainly to promote the State ascendancy over private enterprises, either Chinese or foreign. Therefore the official policy preference of the Nationalist Government leaned toward State-owned Companies where the State formed the sole shareholder, or State-holding Companies in which the State controlled parent companies, or Joint Companies in which the State and private individuals jointly invested.

In addition, the Nationalist Government endeavoured to retain government control over companies in a number of critical sectors, the focus of which was to establish the State involvement within public firms. As a result, government controlled enterprises expanded rapidly and soon became the predominant player in the national economy.

In this political economy context under the Nationalist Government, corporate regulations developed further. In 1929, the previous compact Companies Act was comprehensively amended and expanded to include 233 Articles. The 1929 Company Law, as effective in July 1931, differentiated itself significantly from its predecessor in many aspects.

For instance, Article 1 of the 1929 Company Law presented one of the greatest changes in defining the purpose of a company. Contrary to earlier legislation which defined a company as a legal person formed for the purpose of carrying on commercial transactions, the 1929 law define a company as a legal person “formed with a purpose to profit”. Upon this new definition, the government exempted itself, and its enterprises, from the regulations of Company Law, since their enterprises were regarded as serving public interests rather profits.

There appeared a trend of an increasing percentage of adoption of company as the business organisation within the overall national capital, in spite of the fact that most economic activities were still conducted through traditional partnership or sole trader.

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772 It also featured with a greater degree of regulations on limited share companies and higher levels of punishment for transgressions. Kirby, ‘China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China’ (1995) 54 The Journal of Asian Studies 43
A Chinese survey in 1933 (Table 5.1) indicates that limited liability companies contributed 92.1% of the overall investment.\footnote{Chung, ‘Western Corporate Forms and the Social Origins of Chinese Diaspora Entrepreneurial Networks ’ in McCabe, Harlaftis and Pepelase Minoglou (eds), Diaspora Entrepreneurial Networks: Four Centuries of History (Berg 2005)}

Table 5.1 Corporate registration in China of 1933

<table>
<thead>
<tr>
<th>Corporate Forms</th>
<th>Total Capital Size</th>
<th>% out of overall investment</th>
<th>No. of Company</th>
<th>Average Capital size for each Company</th>
<th>No. of Company established in Shanghai</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unlimited</td>
<td>252,000</td>
<td>2.8%</td>
<td>22</td>
<td>11,454</td>
<td>10</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>214,300</td>
<td>2.4%</td>
<td>27</td>
<td>7,937</td>
<td>15</td>
</tr>
<tr>
<td>Limited Liability</td>
<td>8,292,154</td>
<td>92.1%</td>
<td>52</td>
<td>159,464</td>
<td>34</td>
</tr>
<tr>
<td>Joint-Stock Limited</td>
<td>240,000</td>
<td>2.7%</td>
<td>6</td>
<td>49,000</td>
<td>5</td>
</tr>
<tr>
<td>Partnership</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>8,998,454</strong></td>
<td><strong>100%</strong></td>
<td><strong>107</strong></td>
<td><strong>84,097</strong></td>
<td><strong>64</strong></td>
</tr>
</tbody>
</table>


Another trend of the corporate evolution was the nationalization of private industries and the planned development of a State industrial sector. Committed to the state-led development of all basic heavy industries and infrastructure, for example, the Nationalist Government in 1935 nationalized all the leading commercial banks, among which were several of the most prominent limited share establishments.\footnote{Kirby, ‘China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China’ (1995) 54 The Journal of Asian Studies 43}

With the onset of the Sino-Japanese War in 1937, the Nationalist Government’s statist tendencies went even further. The government assumed much wider powers to nationalize various industrial sectors, to take direct control of the manufacturing of consumer products and to assume the management power of firms that failed to comply with the government policy. By 1943, 70 per cent of the total paid-up capital of enterprises had been controlled by the National Government.\footnote{James Chieh Hsiung and Steven I. Levine, *China’s Bitter Victory: The War with Japan, 1937-1945* (M.E. Sharpe 1992)}

In this process, the Government also created a great variety of organizational and regulatory structures, among which was the state assets management agency: the National Resources Commission (NRC). At least 100 companies were run as purely
administrative units; some others were sole NRC-owned companies; many others were public-private partnerships, with NRC holding at least a 51% share. In industrial sectors like mining, firms were organized as limited joint-stock companies, which were owned jointly by the NRC and provincial governments. For enforcing governmental policy throughout these enterprises, the NRC and its superior authority, the Ministry of Economic Affairs, had issued a large amount of regulations such as the requisite by-laws, rules, and enforcing measures.\textsuperscript{776}

The function and power of this NRC is rather similar to another authority found in current mainland China, i.e., State-owned Assets Supervision and Administration Commission of the State Council (SASAC). As a special commission under the direct authority of the State Council, the SASAC is responsible for managing China’s State-owned Enterprises, including appointing top executives and approving any exchange of stock or assets, as well as drafting rules regulating issues involving SOEs.\textsuperscript{777} For example, the SASAC has been involved in the promulgation of various takeover regulations such as the 2006 \textit{Provisions on Acquisitions of Domestic Enterprises by Foreign Investors}, the 2005 \textit{Interim Administrative Measures for the Transfer of State-owned Shares of Listed Companies} and others.\textsuperscript{778}

Upon China’s victory in the WWII, the State monopoly of the industry and the capital was further strengthened. For example, the government monopolized the whole banking system, also controlled 80% of total industrial capital.\textsuperscript{779}

The 1929 Company Law could not sufficiently accommodate the new normal of state controlled corporate market. The demand for a new company law was also echoed

\textsuperscript{777} Article 11, The Law on the State-Owned Assets of Enterprises
\textsuperscript{778} See previous chapter 3 on China’s takeover regime.
\textsuperscript{779} In the post World War II years, the state assumed an important role in the economy of most OECD Member states as a regulator and (with the exception of the US) as an important owner of productive assets in the economy. The reasons for a big state were multiple: there was a strategic and political economy dimension in the context of the cold war; there was a need to address income inequality in earlier forms of unbridled capitalism; there were concerns with consumer welfare, as natural monopolies were deemed hard to contain within "generic" competition rules; there were also financial considerations in a world where large capital flows were mostly state-related and the vast sums of capital needed to finance infrastructure investment could only be supplied with the direct participation of the state.
with the end of the extraterritorial jurisdictional privilege previously enjoyed by foreign investors in China.\textsuperscript{780} The Government, therefore, needed to update law to be applicable to foreign companies operating within the territory of China.

The 1929 Company Law then went through five revisions and was ultimately republished as the New Company Law in 1946. The main theme of the New Company Law of 1946 further leant to transforming public companies into State-dominated firms. For example, the Government was empowered to “exercise its supervisory power as an administrative agent” for those companies involving private investors, no matter what percentage of the State-owned shares.\textsuperscript{781}

\subsection*{5.3 Legacies of Original Conditions of Legal System and Corporate Regulations}

As suggested by the law and finance scholars, the concept of legal origin is referred as the style of social control of economic and other aspects of life. The legal origins theory traces the styles of social control under different legal systems to diverse perception about law and its function that countries developed centuries ago.\textsuperscript{782} The above discussion has established that contemporary Chinese legal system is a blended style of social control as a product of three main legal origins. The following section summarizes key legacies of these original conditions. These featuring legacies have persisted and penetrated into the organization of the regulatory institution, as well as beliefs of the society as towards the takeover regulations in China.

\subsubsection*{5.3.1 Law as a Political Tool for the Interests of the State}

Under the ancient legal tradition, the primary concern of the legal codes and legal philosophy was the State interests in maintaining a desired social and political order

\textsuperscript{780} Although the entire legal-reform effort since the late Qing had, \textit{inter alia}, aimed at ending extraterritoriality, it was actually China’s wartime status as an ally, not the quality of its laws that in 1943 prompted Britain and the United States to relinquish the extraterritoriality.

\textsuperscript{781} Wei, ‘The Historical Development of the Corporation and Corporate Law in China’ (2002) 14 Australian Journal of Corporate Law 240

\textsuperscript{782} Porta, Lopez-de-Silanes and Shleifer, ‘The Economic Consequences of Legal Origins’ (2008) 46 Journal of Economic Literature 285
in the society: law and regulations were mainly viewed as one type of political tool to enforce the mandate of the State.\textsuperscript{783}

The heavy utilitarian and instrumentalist attitude towards law was also evidenced in the larger part of legal modernisation throughout the 20\textsuperscript{th} century. The commencement of law reform at the turn of the 20\textsuperscript{th} century by the Qing Government was clearly a “desperate last effort to save the Dynasty from collapse” under both internal and external pressures.\textsuperscript{784} The following legal reforms and resulted legislation under the reign of the Republic or the Communist were also primarily utilized as critical tools to implement political economic reforms. Law and its application were continuously viewed as a political tool for, to borrow Marxist terminology, “the ruling class rather than as a protector for the ruled.”\textsuperscript{785}

In addition, the corporate practice and regulatory experiment at the first half of the 20\textsuperscript{th} century presented the State involvement as the most distinctive characteristic. At its first stage of development, Chinese entrepreneurs sought for support from government to compete against foreign competitors. They were willing to enter into a relationship of dependence on the government. Meanwhile, the Government responded positively to this request and campaigned aggressively for the State involvement in the first tide of corporate operation as its financial capacity had been constrained to continue a full control of the national economy.\textsuperscript{786}

Since then, corporate regulations have been devised and revised many times and imprinted with political agendas from different governments. Nevertheless, the State involvement as a feature has never faded away.\textsuperscript{787} In fact, the government has continuously refreshed the corporate regulations to bring the corporate system under stronger State control.\textsuperscript{788}

\textsuperscript{783} See also Qu, \textit{Law and Society in Traditional China} (Hyperion Press 1980); Bodde and Morris, \textit{Law in Imperial China} (Harvard University Press 1967)

\textsuperscript{784} Chen, ‘The Transformation of Chinese Law - From Formal to Substantial’ 37 Hong Kong Law Journal 689

\textsuperscript{785} Ibid

\textsuperscript{786} From the mid-19th century, the Qing Government was under consistent pressure to increase its military spending. This resulted in the available funds being heavily allocated to national defence. Consequently, the government’s capacity to develop civil industries suffered. Wei, ‘The Historical Development of the Corporation and Corporate Law in China’ (2002) 14 Australian Journal of Corporate Law 240


\textsuperscript{788} Wei, ‘The Historical Development of the Corporation and Corporate Law in China’ (2002) 14 Australian Journal of Corporate Law 240
The current regulatory regime over takeover market also shares the same feature, where the regulation has served as a political tool to enforce the State’s mandate to improve corporate governance, especially within SOEs. The adoption of the takeover market and the adaption of takeover regulation at the turn of 21st century is only the evidence of the penetration of legal origins by a body of formal corporate regulations which was introduced at the beginning of last century.789

5.3.2 Law as an Administrative Tool for Governing by the State

Under ancient Chinese political and legal system, there was no concept of the separation of powers among the legislature branch, the executive branch and the judiciary branch. The legal apparatus of ancient China was nothing but an integral component of the administrative system. Law was seen as a tool for the bureaucratic officials with its promulgation undertaken by the central administration representing emperors. The jurisdiction over litigations was primarily vested: at the central government level, in the ministries such as the Bureau of Punishment, the Bureau of Revenues, and the Dalishi; at the local government level, in the governors of local governments as a part of their general administration.790

Since the first days of legal modernisation was commenced at the beginning of 20th century, the executive offices of both the national and the local governments have continued the traditional practices and formulated law and regulations in formats mostly as executive orders to implement policy. They were directly promulgated and enforced either by the ministers of relevant administrative ministries or by the chiefs of local Provincial governments.791 For example, it was the newly created Ministry of Commerce who promulgated and published the very first Companies Act in China in January of 1904.

This feature is also evident within the current takeover regulatory regime. The primary source of takeover regulations is an administrative regulation –Takeover Measures – produced by the CSRC, a ministry level central governmental entity. The

789 See the next chapter 7 for further discussion from the political economy analysis.
CSRC functions as the main regulator with wide authority combining the legislative power, the adjudicative power, and the enforcement power.\textsuperscript{792}

5.3.3 Law as a Supplementary Tool for Resolving Disputes

In ancient China, with Confucianism became the State orthodoxy, \textit{Lizhi} or moral education were endorsed as the ideal way of governing and controlling the society. The term “law”, with its first and primary meaning being the penal code, was more a synonym for the punishment for severe breach of the moral principles. Hence cultivated was the perception of the governments towards law as the supplementary means for social control and the general disapproval of the society towards the judiciary as to resolve disputes. In addition, commercial trades were restricted and civil or commercial disputes were treated as “trivial matters” of secondary interest to the State. The consequence was that a formal civil/commercial law, as a separate field, simply did not come into existence.\textsuperscript{793}

Meanwhile, legal practitioners with independent status and competent knowledge did not exist in the ancient time. On the one hand, as for officials acting as judges, their discretion was limited by the imperial policy, which was to protect the authority of the emperor as the sole source of law. Adjudicating officials, therefore, applied only those rules emanating from emperors, rather than invent rules deriving from cases.\textsuperscript{794}

On the other hand, ancient Chinese law has always discouraged barratry. For example, the article 157 of the Qing Code provides that “whoever with intent to make profit, incites or contracts for the management of any lawsuit of another, shall be punished with imprisonment for not more than one year, or detention or a fine of not more than five hundred yuan.” The same article further prescribes that “whoever makes the commission of an offense under the last section a business shall be punished with imprisonment for not more than three years in addition to which a fine of not more than two thousand yuan may be imposed.”\textsuperscript{795}

\textsuperscript{792} For further discussion on the sources of takeover rules in China and the functions of the CSRC, please refer to the chapter 3.

\textsuperscript{793} Further discussion is under the supra section 5.2

\textsuperscript{794} Also to ensure uniformity in the application of law throughout the imperial territory. See MacCormack, \textit{The Spirit of Traditional Chinese Law} (University of Georgia Press 1996)

\textsuperscript{795} Article 157, Great Qing Code
Consequently, neither an independent nor competent judicial system with active lawyers functioned in China upon the commencement of legal modernisation at the turn of 20th century. Judges, with insufficient knowledge and experience to handle sophisticated matters such as those involving corporate disputes, were frequently subject to the intervention of powerful politicians or organizations. For example, for a period of three decades after the establishment of the central communist government in 1949, the judiciary system and judges were subject to a wave after another of political movement until its full abolishment between 1960s and 1970s.

As a result, a judiciary contribution to the development of takeover regulatory regime was unforeseeable in China. In contrast, the so-called judge made law, developed by the England’s central royal courts, forms the dominant feature of the common law system as represented by in the US and the UK. In particular, the rules of the fiduciary duties, which has been the fundamental criteria as applied by the Delaware court to assess the validity of directors’ actions in face of hostile takeovers, originates from a separate court of chancery.

**Conclusion**

A twofold finding regarding the legal origins theory could be made here. The main argument of legal origins theory, as discussed in chapter 4, is that the regulatory style of present day is subject to the particular legal infrastructure or order as crystallized, in the case of most countries, at some point in the nineteenth century or at the latest in the early twentieth century. This chapter confirms that it is indeed at the turn of 20th century that a set of original conditions were crystallized and subsequently set the path for the contemporary Chinese legal system and the pattern of China’s takeover regulations.

The legal origins theory also suggests the classification of legal systems into different legal families as a foundation of comparing the effects of legal origins. This

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797 Please refer to supra section 5.1.2 for further discussion on the legal development under the central communist government.

suggestion is not analytically useful for a better understanding of the pattern of the Chinese takeover regulations. The contemporary Chinese legal system features a hybrid system with a blended style of social control with three streams of legal origins. For a hybrid jurisdiction like China, one critical challenge is to keep track of its legal development, and to identify the dominant legal origins for the particular regime of law being examined.

In conclusion, to understand the featuring pattern of Chinese takeover regulatory regime, it is imperative to appreciate the original conditions of modern Chinese legal system and the early experience of corporate practice and regulations. The variety of original conditions are set in the first half of the 20th century upon the intrusion of the Western system and the wrecking of the traditional society in China. On the one hand, these original conditions have constituted the historical context of the modern legal system; on the other hand, many fundamental elements of these origins are so hard-wired that changing them would be extremely costly and that reforms on the existing path must be sensitive to legal traditions.799

This Chapter has established that, firstly, many hundred years of legal practice and deeply rooted legal philosophies such as Confucianism and Legalism as existed in the ancient Chinese society constitute the critical origin of contemporary China's legal system. The application and perception of law as the secondary strategy of social control have created, *inter alia*, a society featuring the antipathy to adjudication according to law, and an organization of the regulatory institutions with the week judiciary authority.

Secondly, the original conditions are also determined by the internal and external pressures as imposed on the governments governing China through the 20th century. The internal pressure to create a modern society and the external pressure to relinquish extra-territorial privileges by foreign powers forced the successive governments to, *inter alia*, adopt a codification legal system as an instrument to achieve its purposes.

799 See further discussion in Part III on the evolution of takeover regulation from the politician economy perspective.
Thirdly, as long as the Communist Party started its reign over local areas as early as the 1930s and eventually acceded to be the ruling party of the national government after 1949, the communist political ideology has also penetrated into the construction and practice of Chinese legal system.

Finally, the early experience of corporate operation and regulations in the first half of 20th century also set the path of later development of corporate governance and regulations, including the takeover regulations. One persisting feature, for example, is strong State involvement. The study of early development of corporate governance in China, therefore, is “more than just a piece of interesting history”\(^{800}\). It was rather the beginning of China’s attempt to create a modern system of corporate governance; an effort continues to this day and still deals with many issues that already appeared in 1904.

In short, the pattern of current takeover regulatory regime in China is pre-determined by a set of original conditions of modern legal system and early corporate operation and regulations. The instrumental view of law, by which law is treated as a political tool, an administrative tool, and a secondary tool for social control, has persisted both in modern legal system in general and current takeover regulations in specific.

Yet the basis on which the original conditions should have such a powerful and long-lasting effect requires further clarification. Without a clear understanding of why such strong path dependencies persist, it is hard to draw policy implications or to determine the optimum options available to policy-makers contemplating legal and institutional reform. This understanding will be achieved by the introduction of the third pillar of path dependence framework, namely the self-reinforcement effects. The discussion on this pillar will be the focus of the following Part III.

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Part III: Understanding the Regulatory Heterogeneity from the Self-Reinforcing Path Dependency

From the Perspective of Increasing Returns and Political Economy Theory

This part of the thesis focuses on the third underpinning pillar of the comprehensive path dependence theory, namely the self-reinforcing path dependency, to interpret the diverse regulatory equilibria of takeover regulations. To achieve this purpose, this part incorporates the political economy literature into the self-reinforcing path dependency theory. Political economy literature approaches legal developments with the observation that public policies, including institutions and regulations, are subject to political economy constraints. These constraints include macro variables such as the political ideologies, the economic structures; and micro variables such as interest groups, the major political parties, and etc.

The analysis is to test one of the hypotheses as proposed in chapter 1, namely, the takeover regime has demonstrated lock-in effects due to the self-reinforcing path dependence phenomenon caused by the embedded political economy context. The evolution of legal systems is endogenous to the processes of economic and political development. A path dependency theory incorporating the political economy literature thus accounts for the differences of takeover law and practice models among examined jurisdictions, i.e., the UK, the US and China.
Chapter 6: The Political Economy of Takeover Regulatory Regime in the US and the UK

Introduction

This Chapter addresses two questions: 1) how to account for the regulatory heterogeneity from the self-reinforcing path dependency? 2) has regulatory choice become embedded within the political economy context of the UK and the US? The first section provides a review of the self-reinforcing path dependency theory with a general discussion of so-called “increasing returns” effect or the positive feedback process. The second section aims to enrich the self-reinforcing path dependence theory by incorporating the political economy literature. This political economy literature looks at how legal institutions interact with political influence to create policy outcomes and regulatory responses. The third section will employ the enriched self-reinforcing path dependence theory to examine the driving forces behind the shape of takeover regulation in the UK and the US.

6.1 Revisiting the Self-Reinforcing Path Dependency

The self-reinforcing path dependency theory suggests that preceding steps in a particular path induce further movement in the same direction. This theory is well captured by the concept of increasing returns process. The basic rationale is the relative benefits of the current activities, which are embedded within the existing contextual settings, increase over time as compared with other possible alternatives. As suggested by Margaret Levi.

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802 Increasing returns process could also be described as positive feedback process. For some theorists, increasing returns are the source of path dependence; for others, they typify only one form of path dependence. See supra Chapter 1, also ibid
Path dependence has to mean ... that once a country or region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice.

It is suggested that the increasing returns would magnify insignificant circumstances hence “tip a system into the actual selected outcome”.  

For example, when a new technology is subject to increasing returns, - “being the fastest out of the gate” - becomes critical to achieve a decisive advantage over its competitors.  

This occurs because with increasing returns, actors have strong incentives to focus on a single alternative and to continue down a specific path once initial steps are taken in that direction. Once an initial advantage is gained, increasing returns effects may lock in this technology, and competitors are excluded.

Not all dynamic systems, of course, are prone to increasing returns.  

Arthur in his seminal book on increasing returns addresses conditional features that give rise to increasing returns in the development of technologies. The conditional features include large set-up or fixed costs, learning effects, coordination effects, and adaptive expectations. The development of the QWERTY typewriter keyboard provides the most often cited example of the characteristics and consequences of increasing returns processes.


Although it is not necessarily the most efficient alternative in the long run. David, ‘Clio and the Economics of QWERTY’ (1985) 75 The American Economic Review 332


Paul Krugman, the 2008 Nobel Prize laureate in economics, applied the theory to explain the persistence of the US manufacturing belt, suggested that “if there is one single area of economics in which path dependence is unmistakable, it is in economic geography — the location of production in space.”


When set-up or fixed costs are high, individuals and organizations might have a strong incentive to identify and stick with a single option.

Knowledge gained from learning or repeated operation of complex systems might lead to higher returns and spur further innovations in related activities.

Coordination effects confer benefits for taking the action similar to others, which in turn attracts more participants into the selected path.

This feature is related to coordination effects, but derives from the self-fulfilling character of expectations. Projections about future aggregating used patterns lead individuals to adapt their actions in ways that help them to make those expectations come true hence enhance the likelihood that the set of similar conditions would persist in the future.

Notably, the historical accuracy of the QWERTY example has been questioned. See Stan J. Liebowitz and Stephen E. Margolis, ‘The Fable of the Keys’ (1990) 33 Journal of Law and Economics 1 (arguing that the
The “QWERTY keyboard” gets its name from its six upper left-hand keys. According to Paul A. David, the QWERTY keyboard’s ascendance into dominance during the 1890s occurred largely because of the advent of touch typing. The early adaptation of touch typing to the QWERTY keyboard led to significant fixed costs, learning effects, coordination effects, and adaptive expectations that favored the QWERTY keyboard arrangement.\(^{815}\)

Because of these strong learning, coordination, and expectation effects, the QWERTY keyboard’s early dominance allowed it to become the dominant keyboard arrangement despite the apparent superiority of later-developed keyboard arrangements such as the Dvorak keyboard layout. Consequently, the increasing returns characteristics of the typewriter keyboard process have locked the industry into standardization of the “wrong system.”\(^{816}\)

These interpretations from the increasing returns perspective about technology are not merely about the technology per se but also about the “characteristics of a technology in interaction with certain qualities of related social activity.”\(^{817}\) The identified features which are conducive to increasing returns path dependency provide a foundation for developing hypotheses about when the increasing returns path dependence is likely to operate in other areas of social science research.

The elements of increasing returns path dependence provide the core for another Nobel Prize laureate in economics, Douglass C. North, in his sweeping enquiry into

\(^{815}\) Typists had to invest significant time into learning a particular keyboard arrangement; therefore it was costly for typists who were familiar with one keyboard arrangement to learn a different one. Coordination effects also emerged because the new typewriter system required technical interrelatedness between the keyboard and the touch typist’s memory. As a result, the process possessed significant economies of scale: the larger the number of individuals familiar with a particular keyboard arrangement, the lower the overall user cost of a typewriter system based on that arrangement. Moreover, adaptive expectations solidified the QWERTY keyboard’s dominance: employers purchased QWERTY keyboards because they expected more typists to be able to use them than the alternative available arrangements, and typists invested in learning the QWERTY keyboard arrangement because they expected that more employers would supply it. David, ‘Clio and the Economics of QWERTY’ (1985) 75 The American Economic Review 332

\(^{816}\) See Paul A. David, At Last, a Remedy for Chronic QWERTY-Skepticism, Paper provided by EconWPA in its series Economic History with number 0502004. (2005).

economic history and institutional change. 818 According to North, institutions are “the rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction” 819 Their change are subject to increasing returns as manifested in the technology development.

On the one hand, incumbent institutions could generate powerful inducements that reinforce their own stability and further development; on the other side, new institutions tend to entail high fixed or start-up costs, considerable learning effects, coordination effects, and adaptive expectations. Both incumbent and new institutions form the interdependent web of “Institutional Matrix”. The Matrix produces massive increasing returns hence a powerful path dependent development. This explains the anomaly of continued divergence of institutional development and economic performance across the world. 820

Paul Pierson, a prominent political science scholar, 821 suggested that the public policy sphere is also “intensely” prone to the increasing returns path dependency. 822 Public policies are grounded in law and backed by the coercive power of the State. They shape the incentives and resources of social actors, individuals or organizations. When one public policy is chosen over another, individuals or organizations invest large sunk costs, *inter alia*, to develop specialized knowledge, to coordinate with each other, and to enhance particular political environment in their favour. 823

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823 See also Richard Rose, ‘Inheritance before Choice in Public Policy’ 2 Journal of Theoretical Politics 263
These individuals or organizations use political authority to uphold an existing arrangement, either the formal institutions or the various public policies, for the purpose of maintaining or enhancing their power. “When certain actors are in a position to impose rules on others, the employment of power may be self-reinforcing.” This nature and impact of public policies cause increasing returns and a self-reinforcing dynamic in the political world. The increasing returns path dependency is a critical concept to understand the sources of political stability and change.

To sum up, scholarship of the economic studies and a large follow-up in other fields have provided the “most fertile ground” for the self-reinforcing path dependence discussion. Not only have these studies clarified the principal implications of the increasing returns property but also have identified many of the specific aspects of a particular social environment that generate such a property.

6.2 Incorporating the Political Economy Theory into Self-Reinforcing Path Dependency

The political economy theory has been profoundly developed and broadly applied to, inter alia, account for the global evolution of corporate governance and embedded legal systems. In general, the political economy approach looks at how legal
institutions interact with political economy influences from two aspects. The first aspect focuses on the macro political economy: that is, the way in which the domestic political economy environment shapes a legal system. The other one focuses at a more micro level on the role played by particular interest groups. The following section reviews and incorporates political economy approach from both the macro and the micro perspectives to the increasing return path dependency theory.

### 6.2.1 Macro Political Economy Perspective

The macro political economy model holds that corporate governance and the embedded legal systems do not exist in a vacuum. Instead, they are “endogenous to the evolving political economy context”. In this aspect, Mark J. Roe has been praised as one of the most influential scholars who open wider the door for exploration of political influences on corporate law and practice.

Roe’s account to politics as “continuous, ongoing, and primary variables” on the corporate governance model has been attributed as the foundation of the “political theory” of corporate law studies. On the one hand, his research has thoroughly mapped the interaction between the political economy and the corporate governance. On the other hand, his research has advanced the understanding in further developing the political economy interpretation of the legal development in general.

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831 Mark J. Roe is currently a David Berg Professor of Law at Harvard Law School, where he teaches corporate law and corporate bankruptcy. Roe has written over 50 articles, 8 books and many other publications in the area of corporate governance research. For a full list to his publication, [http://hls.harvard.edu/faculty/directory/10725/Roe/bibliography](http://hls.harvard.edu/faculty/directory/10725/Roe/bibliography)
For example, in the early 1990s, Roe laid out a political theory of corporate governance with the publication of a book titled *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*. As the title suggests, the book’s central argument was that critical elements of the contemporary system of corporate governance in the US reflected distinctive aspects of American politics especially the widespread public ideology hostile to powerful financial interests.

About a decade later in another book titled *Political Determinants of Corporate Governance*, Roe articulates a more comprehensive theory of comparative politics and corporate governance, which makes a distinction between social democracies and other types of political systems. These different political systems, for Roe, are the central variable of the political economy determinants influencing corporate governance models.

Apart from Roe, other legal scholars have also observed that macro-political economic context including ideological factors and electoral systems have imposed huge influence on the policy preferences and regulatory outcomes of corporate governance. For example, it is documented that the majoritarian electoral system in the Anglo-Saxon countries, where winning the majority of pivotal districts ensures victory, has subject these countries to a legal system preferred by shareholders with strong shareholder protection but weak employment protection. In contrast, the proportional voting system in the continental European countries where winning a

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836 This early statements of a political theory of corporate governance were largely based on the US case with some limited reference to its German and Japanese counterparts. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press 1994)

837 It was a mistake, therefore, to see the US system of corporate governance as the product of an economic process of selection through which the most efficient system won out. Ibid; See also O’Sullivan, ‘The Political Economy of Comparative Corporate Governance’ (2003) 10 Review of International Political Economy 23

838 Mark J. Roe, *Political Determinants of Corporate Governance* (Oxford University Press 2006)

839 Social democracy refers to a political system committed to private property but governments play a large role in the economy. This political system emphasizes distributional considerations, and favours employees over capital-owners when both conflict. Social democracy presses managers to stabilize employment, to forgo some profit-maximizing risks with the firm, and to use up capital in place rather than to downsize when markets no longer are aligned with the firm’s production capabilities. Social democracy also gives voice to claims on the firm in addition to those of the shareholders and employees: income distribution, regional or national development, social welfare and social stability, and nationalism, to name a few. Roe, ‘Political Preconditions to Separating Ownership from Corporate Control’ (2000) 53 Stanford Law Review 539

840 See also: Mark J. Roe and Travis G. Coan, ‘Financial Markets and the Political Center of Gravity’ [Now Publishers] 2 Journal of Law, Finance, and Accounting 125 This recent research further buttress the importance of a nation’s basic left-right political orientation in explaining financial market outcomes.

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majority of the votes is crucial, have produced a legal system with weak shareholder protection but strong employment protection.841

As the main focus of this thesis is concerned, a macro-political economy context is also one of essential explanations for the diverse regulatory patterns of takeover regulation.842 There appears a “rich web of mutually dependent relationships” which forms the “political ecology” of takeovers, as suggested by another prominent corporate law scholar.843 In other words, takeovers are embedded in and dependent on “complex economic corporate governance and political environments”.844

6.2.2 Micro Political Economy Perspective

Another strand of the political economy approach focuses on the micro level of the roles played by particular interest groups. This interest-group approach is closely related to the Economic Theory of Regulation, which assumes that legal rules are demanded and supplied like many other commodities.845 Accordingly, law and regulations are supplied to those groups who successfully bid for it with compensation in the form of political support, campaign contributions, lobbying expenditures, and so on.

Regarding corporate governance and takeover regulation, influential interest groups with various political economy preferences have been observed to successfully project their power in “pressing for one set of rules or another favourable to them”.846 The

844 Ibid
846 Roe and Vatiero, ‘Corporate Governance and its Political Economy’ in Gordon and Ringe (eds), The Oxford Handbook of Corporate Law and Governance (Oxford University Press 2017) <Available at SSRN:
incumbent deploy their advantages to reinforce further their entitlements, and exert a force of conservatism against a shift away from favoured regulatory arrangement.  

The contour of a given corporate governance system or takeover regulatory model, therefore, reflects a competitive equilibrium among different interest groups involved.  

For example, corporate insiders, institutional shareholders, and entrepreneurs have taken advantage of their strengths to shape the pattern of corporate governance and the level of investor protection. Consequently, some countries have adopted rigorous prohibitions on insider trading and strong protection of minority shareholders; while some other countries have encouraged block holding by allowing pyramid leveraging and cross-shareholding and offered weak protection to minority shareholders.

Apart from these interest groups who are directly involved in corporate operation, third party advisors such as financial intermediaries, lawyers or auditors also invest large set-up or fixed costs in specific human capital for becoming specialists in one set of corporate rules. For example, auditors were found to be one of the main proponents for American corporate financial regulations including the Foreign Corrupt Practices Act of 1977 (FCPA), or the Sarbanes-Oxley Act of 2002 (SOX). Since the passage of these regulations, auditors have derived huge benefits such as higher auditing fees, more arduous auditing needs, and economic concentration in the accounting industry.

A similar observation could be made in respect to the increasing returns of the judges, regulators, or even legislators in regard to the corporate rules making and enforcing.

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848 See also Raghuram G Rajan, ‘Rent Preservation and the Persistence of Underdevelopment’ (2009) 1 American Economic Journal: Macroeconomics 178


851 Discuss further in the following section 6.3.2 concerning mercantile banks in the City of London

852 Discuss further in the following section 6.4.4 concerning lawyers in the State of Delaware

Judges, regulators, and congressmen, who are experts on the existing domestic corporate rules, can also form a rent-seeking coalition in order to preserve their quasi-rents related to their human capital. Therefore, these interest groups could be keen in preserving the existing legal paradigm of corporate governance. A country’s legal system influenced by interest groups could induce powerful locked-in effects, hence a self-reinforcing path dependency phenomenon.

6.2.3 Conclusion and Critiques

“Without a political economy analytic, one can neither fully understand the structure of the modern corporation nor account for international difference.” The regulatory heterogeneity in existence have been greatly influenced by macro and micro political economy determinants. These determinants have caused the increasing returns effects, contributed a path dependency phenomenon in the shaping of diverse regulatory patterns.

But the existing political economy literature is not free from critiques. Firstly, the analysis on the links between political economy and corporate governance has overwhelmingly focused on the former as a barrier to change of governance and regulation of corporate operation. But political economy determinants can also play a crucial role in promoting change. As discussed in the following sections on the formation and evolution of takeover regulation in the UK and the US, changes have been instigated or supported by political economy constituencies.

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858 Further discussion is available at: Roe and Vatiero, ‘Corporate Governance and its Political Economy’ in Gordon and Ringe (eds), The Oxford Handbook of Corporate Law and Governance (Oxford University Press 2017) <Available at SSRN: http://ssrn.com/abstract=2588760 or http://dx.doi.org/10.2139/ssrn.2588760>
859 Another documented example is the recent change in the attitude of large German financial enterprises to their traditional role in the German system of governance. O'Sullivan, ‘The Political Economy of Comparative Corporate Governance’ (2003) 10 Review of International Political Economy 23
Secondly, it should be noted that not all jurisdictions and their governance systems are subject to one ubiquitous combination of political economy variables. Instead, it is imperative to assess the actual impacts of different variables according to the country-specific governance arrangements in practice. For example, the social democratic analytics explains corporate governance and Takeover Regulation in the Western nations, but is less convincing at explaining the situations in many other more authoritarian nations.\textsuperscript{860} Even between Anglo-Saxon countries like the US and the UK, as further discussed in following sections, political economy determinates of regulatory patterns differ regarding the takeover markets in the UK and the US.\textsuperscript{861}

The following sections will endeavour to apply the self-reinforcing path dependency from the political economy aspects to account for the evolution takeover regulation in the UK and the US.

6.3 The Political Economy of the Takeover Regulation in the UK

The takeover regulation in the UK features a \textit{sui generis} Panel system. As discussed in chapter 2, for decades an autonomous regulatory body, i.e., the Takeover Panel, has administered and enforced the market based rules which are set out under the comprehensive Takeover Code. Other regulators, including the courts and the governmental agencies, have refrained from exerting jurisdiction over British takeover market. As from 2006, the Panel system has been placed on the statutory footing pursuant to the transposition of the Takeover Directive 2004. Nevertheless, the essential feature of the Panel system as a separate and independent regulatory model persists; the principal regulatory purpose remains the same, i.e., to ensure the fair and equal treatment of the shareholders of the target companies; the fundamental pillars of the rulebook – the non-frustration rule and the mandatory bid rule – endure through time.\textsuperscript{862}

\textsuperscript{860} Roe and Vatiero, ‘Corporate Governance and its Political Economy’ in Gordon and Ringe (eds), \textit{The Oxford Handbook of Corporate Law and Governance} (Oxford University Press 2017) <Available at SSRN: http://ssrn.com/abstract=2588760 or http://dx.doi.org/10.2139/ssrn.2588760>

\textsuperscript{861} See elaborated discussion in infra section 6.3-6.4

\textsuperscript{862} The Takeover Panel, \textit{Report and Accounts for the Year Ended 31 March, 2016} (July 2016) Page 1
To explain the persistence of the UK *sui genus* Panel system, chapter 4 has referred to the path dependency theory on initial conditions to discuss the original conditions from which the self-regulatory Panel system come to existence. This section will apply the enriched self-reinforcing path dependency theory, as developed in the previous section, to explore British political economy context within which the *sui generis* Panel system have been embedded. The British political economy context can be attributed to two exceptional elements, 1) the macro political economy matrix shaped by the hegemonic City and the passive State, and 2) the micro political economy interest groups represented by the Bank of England, the institutional investors and mercantile banks.

### 6.3.1 The Macro Political Economy Matrix: The City – State Relationship

The financial and related professional services industry has been a key driver of the British economy.\(^{863}\) This industry has played the essential role in raising capital for manufacturing companies, producing a range of investment opportunities for individuals and enterprises, and providing a substantial amount of employment for the nation. In the year of 2015, for example, the financial services trade records a surplus of $97bn and contributes 12 percent of economic output and employs nearly 2.2 million people.\(^{864}\) The surplus of the British financial services trade is more than the combined of the next four leading countries (US, Switzerland, Luxembourg and Singapore). (Graph 6.1)

Graph 6.1: Largest Global Net Exporters of Financial Services

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864 TheCityUK, *UK Financial and Related Professional Services: Meeting the Challenges and Delivering Opportunities* (August 2016)
British financial industry has bred an exceptionally high concentration in the City of London (City), particularly in the “square mile”\footnote{Talani, Globalisation, Hegemony and the Future of the City of London (Palgrave Macmillan 2012) Page 35}. The City forges the center of the British finance capital and the conglomerate of financial marketplaces. Financial institutions in the “square mile” serve as middlemen and intermediaries concerned with the provision of financial services both domestically and abroad, ranging from insurance to brokerage activities, from trading in secondary markets to providing professional services.\footnote{Ibid Page 26} (Graph 6.2)

Graph 6.2: Key Financial Centres, Today and Tomorrow
The hegemonic position of the financial services industry, as provided primarily by the City, in British society can be largely attributed to its historic roles in funding the British Monarchy/State, and its economic prominence to the British capitalism. This hegemonic position is also resulted from other vital factors, including but not limited to: 1) an early integration of the financial and ruling landed elites which transferred British financial and banking elite to the carrier of feudal, aristocratic cultural and social values; 2) the City’s economic cohesion, geographical concentration and physical proximity to, and institutional connections with, the British government.

The City’s hegemonic position has rendered an exceptional political economic equilibrium within Britain, which has cultivated a passive attitude of British State

Source: TheCityUK based on Citi, Oliver Wyman and Z-Yen

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867 Ibid Page 202
towards regulatory intervention of its financial industry. For a long period of time before the second half of the 20th century, the UK government has not provided many statutory regulations to regulate capital market; instead, responsibility for maintaining the market order was primarily reserved to the City and its “Pope” – the Governor of the Bank of England which had been a non-state body itself until 1947 – by self-regulatory or market controlled rules.\(^{869}\)

The exceptional political economic equilibrium has also rendered the City a unique role to impose disproportionate influence in the British policy making.\(^{870}\) As suggested by Longstreth, the City has “largely set the parameters of economic policy and its interests have generally predominated since the late nineteenth century. Its dominance has been so complete that its position has often been taken as the quintessence of responsible financial policy.”\(^{871}\)

A laissez-faire approach became British State political preference towards the City and the financial industry. A wide degree of autonomy and discretion of self-regulatory power has been granted to financial institutions in the City. With their discretionary powers, financial institutions have endowed their market controls and further reinforced the City’s hegemonic position.\(^{872}\) This is reflected in many of the classic examples of financial and corporate regulation, whose mark is “still impressed on contemporary self- and market controlled UK approaches” to the regulation of the financial market activities.\(^{873}\)

Regarding takeover regulation, it has been well documented that it is in the exceptional hegemonic position of the City and passive regulatory intervention of the State that the fundamental features of the independent Panel system is embedded and entrenched.\(^{874}\) The State’s role is regarded as one of facilitating and organizing self-

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\(^{870}\) Michie and Williamson (eds), *The British Government and the City of London in the Twentieth Century* (Cambridge University Press 2004) Page 8


\(^{872}\) This political preference has weakened in some extraordinary circumstances, such as the post-World War II period, and recent years after the 2009 financial crisis. Talani, *Globalisation, Hegemony and the Future of the City of London* (Palgrave Macmillan 2012) Page 66

\(^{873}\) Kershaw, ‘Corporate Law and Self-Regulation’ in Gordon and Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2015)

regulatory solutions, while the laissez-faire financial market presents the City’s institutions predominant roles in developing and shaping the Takeover Code and the Takeover Panel.  

For example, when fierce takeover battles emerged in the UK during the 1950s and 1960s, there appeared a “looming threat” from the public demanding for inquiries into take-over bids and the establishment of a statutory authority to police the market for corporate control. The political and industrial consensus was consistent with the longstanding British regulatory style. As the then Lord Mayor of the City of London argued, City institutions “should be left to work out our own solution” to the issues of Takeover Regulation; a direct state interference would represent a “transgression of core tenets of the British way of life” and would be “a grave blow to the country”.  

Despite the reaffirmed governmental assurance, the City is afraid of a potential regulatory paradigm shift. Historically situated, the “looming threat” of the state intervention is a forceful communicative trigger to signal the City and its institutions to organize themselves to address the issues arising from fierce takeover battles. And that is how the Bank of England, one of the key City institutions, spurred to convene a City Working Party, out of which emerged the self-regulatory Panel system, to coordinate City institutions’ efforts to address issues arising from the takeover market. The following section will discuss the roles of these key City institutions in shaping the takeover regulatory regime in the UK.


877 One of the results is the Jenkins Report on Company Law. See further in Richard Roberts, ‘Regulatory Responses to the Rise of the Market for Corporate Control in Britain in the 1950s’ [Routledge] 34 Business History 183  


879 To a limited degree, the British government had indeed acted in 1960 when it amended the Licensed Dealer Rules. Ibid para 3.63  

880 Kershaw, ‘Corporate Law and Self-Regulation’ in Gordon and Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2015)  

881 Roberts, ‘Regulatory Responses to the Rise of the Market for Corporate Control in Britain in the 1950s’ [Routledge] 34 Business History 183
6.3.2 The Micro Political Economy Interest Groups: City Institutions

As discussed in the previous section 6.2.2, legal rules tend to favour the interests of the groups with the greatest influence over the rule-making process. As for the takeover regulation in the UK, the Panel system has been orchestrated principally by powerful City institutions, in particular, the Bank of England, institutional investors and mercantile banks. These groups regularly “rub shoulders” in the one-square-mile district where British financial service community is concentrated. As compared to American counterparts, corporate managers were not a well-organized constituency in the British takeover market, and they had rather weak influence in the formulation of the takeover regulation.

6.3.2.1 Bank of England

There exists the “dialectic relationship” of mutual interest between the City and its political referents, i.e., the Bank in defending the City’s autonomy. The Bank of England (Bank) is a powerful institution charge of the management and control of the finances of the State. Moreover, the Bank also functions as the representative of City’s financial interests and a channel of communication for the City in dealings with the State. It is therefore the trait d’union between the State and the City. Through the roles played by the Bank, the City has been able to influence economic policy making from within the State, which allows the financial industry to control important levers of self-regulatory power.

The interests of the Bank are also aligned with an autonomous financial industry. The Bank, in 1950s and 1960s when the market for corporate control emerged, was solely responsible for overseeing banking and capital markets in the UK. Intervention from

884 Talani, Globalisation, Hegemony and the Future of the City of London (Palgrave Macmillan 2012) Page 31
Talani, Globalisation, Hegemony and the Future of the City of London (Palgrave Macmillan 2012) Page 19
the State means a loss of power by the Bank, which would represent a “significant blow” to the Bank’s role as the City regulator controlling the financial market.\footnote{Kershaw, \textit{Principles of Takeover Regulation} (Oxford University Press 2016) para 3.65} It is hence not a surprise that the Bank has been astute at organizing City’s interest groups to defuse any tendency towards State interference into the autonomy of the financial industry.\footnote{Ibid Para 3.17}

The proactive response to the takeover issues by the Bank represented a good example of its proactive strategy to maintain its “regulatory” interests.\footnote{Ibid Para 3.17} In July 1959, in the wake of Battle for British Aluminium, the Bank swiftly convened a Working Party consisting of the then most powerful interest groups participating in the UK takeover markets to produce a Code of Conduct to govern takeover transactions.\footnote{Kershaw, ‘Corporate Law and Self-Regulation’ in Gordon and Ringe (eds), \textit{The Oxford Handbook of Corporate Law and Governance} (Oxford University Press 2015)} These powerful interest groups are 1) institutional investors, whose interests are directed affected by a takeover bid; and 2) mercantile banks, who are the financial advisors to a takeover bid. By facilitating the production and implementation of policies advocated or preferred by the City, the Bank consolidated its own instrumental power in the political economy system.

\textbf{6.3.2.2 Institutional investors}

The paradigm shift of share ownership from retail investors to institutional investors commenced in Britain in the 1950s, which coincides with the genesis of market for corporate control in Britain.\footnote{Cheffins and Bank, ‘Corporate Ownership and Control in the UK: The Tax Dimension’ (2007) 70 The Modern Law Review 778} As Figure 6.3 shows, institutional investors first started to accumulate significant proportions of shares in British companies in the mid-1950s. By the mid-1960s, they had established themselves at the heart of UK corporate governance.\footnote{See further under previous Section 4.3.2, Chapter 4}

\textbf{Figure 6.3, Institutional ownership (percentage of the UK Stock Market) in the United Kingdom, 1957–1981}
Source: Figure 3.1, Principles of Takeover Regulation (David Kershaw, Oxford University Press. 2016)

The increasingly dominant institutional investors have clear interests in rules that maximize expected gains to them. Institutional investors’ role could be observed at every development stage of the takeover market and its regulatory regime in the UK.\textsuperscript{893} An early example is the battle for British Aluminum, which provided a platform for increasingly powerful institutional shareholders to “flex their muscles”. Institutional shareholders opposed to the Board’s initiative to issue shares to alter control of company without consulting with shareholder. As their response, they sold British Aluminum stock, in a “quick” and “devastating” sale, to TI-Reynolds, who successfully took over the British Aluminum.\textsuperscript{894}

Although institutional shareholders in this battle successfully defeated their board’s unwelcomed proposition by vote with their feet, they are concerned about their rights in the takeover market in future. Swiftly they participated into the working group convened by the Governor of the Bank in July 1959 to devise a code of conduct for


takeover market. In the working group, institutional investors shed their critical influence by having representation with two members, namely, the Association of Investment Trusts and the British Insurance Association.  

Shortly in the autumn of 1959, the working group announced the *Notes on Amalgamation of British Businesses*, which set the foundation for the shareholder interests oriented takeover regime in the UK.

The institutional investors’ engagement, via their representative groups, into the draft of the Notes is one example of their direct influence on rulemaking: “the formation of formal and informal norms that govern the operation of corporate enterprise.” They have been active in lobbying regulators, and in seeding market norms in different corporate regulatory contexts, ranging from the strengthening of preemption rights, the disuse of non-voting shares and other embedded takeover defenses, the strengthening of Listing Rules requiring shareholder consent for major corporate transactions, and the introduction of the Combined Code on Corporate Governance.

There is a second channel by which institutional investors have made a difference to British takeover regime. This second channel is rather indirect: “the institutionalization of the capital markets has been a catalyst in creating conditions based on which the UK takeover market flourished.” In particular, by advancing a proliferation of takeover bids, British institutional investors have pushed another key player of the capital market, i.e., mercantile banks, to alter social and business attitude toward takeover market. Mercantile banks, lucratively rewarded by a vibrant takeover market, are the second force strongly incentivized to engage into the formation of a new takeover regime when regulatory action was coordinated by the Bank of England.

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895 The other members included the Bank of England, the London Stock Exchange, the Issuing Houses Association, the Accepting Houses Committee, and the Committee of London Clearing Bankers.
900 Further discussion is followed in the next section.
901 Kershaw, ‘Corporate Law and Self-Regulation’ in Gordon and Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2015)
6.3.2.3 Mercantile banks

UK mercantile banks had been conventionally pro-management and unfriendly towards takeovers bids. Their attitude changed with the increasing number of takeover events like the battle for the British Aluminium. In these events, institutional investors decisively utilized their dominant power in the capital market, which determined the fate of transactions. Mercantile banks began to realize the financial values of adding “hostile bids to their repertoire of merger and acquisition techniques”. Since mercantile bankers are at the center of a network of advisory services, they are lucratively rewarded from advising takeover bids. Mercantile banks became more interested in fostering a social atmosphere open to takeover bids, and in defusing the public concerns on the influence of institutional shareholder in the market for corporate control.

In addition, mercantile banks comprehended the urge to have impacts on shaping takeover rules that “wedded takeover activity to the financial advisory role”. They also took part in the Working Group convened by the Bank of England via their lobby group, namely the Issuing Houses Association. Tactically, the Issuing Houses Association created a sub-committee consisted only of representatives from four mercantile bankers. As documented, it is this sub-committee who “did most of the work and the drafting” of the Notes on Amalgamation of British Businesses.

The Notes, production of which was controlled by the mercantile banks, hardwired the essential roles and functions of the mercantile bank as financial adviser to a takeover bid process. As roles and functions generate fee income, the Notes and mercantile banks business interests are firmly aligned. For one example of the embedded roles for the financial advisor, a bidder cannot announce his intention to make a firm offer that will include a cash component without a cash confirmation statement from the financial adviser confirming that the cash resources needed to close the deal are

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902 Ibid
903 Harold Wilson’s (Shadow Chancellor) speech of 26 June, detailing the ‘golden handshakes’ of target directors such as Lord Portal, former chairman of British Aluminium. Cited by Kershaw, Principles of Takeover Regulation (Oxford University Press 2016) Para 3.32
904 Kershaw, ‘Corporate Law and Self-Regulation’ in Gordon and Ringe (eds), The Oxford Handbook of Corporate Law and Governance (Oxford University Press 2015)
905 Kershaw, Principles of Takeover Regulation (Oxford University Press 2016) Para 3.66
906 Ibid Para 3.73
available to the bidder. Other examples of the embedded roles for the financial advisor include: the determination of whether or not to make a possible offer announcement; the requirement for certifications from financial advisors in relation to profit forecasts; and target management post-bid remuneration.

6.3.3 Reinforcement of the Panel System

Since its coming to effect in 1958, the Notes have been generally well-received with regular revision and amendments. But the lack of enforcement mechanisms restricted the Notes’ authority in the UK takeover market. There raised a widespread public clamour for regulatory intervention. For example, The Economist once suggested that the widespread evasion of the Notes made them “a dead letter” and suggested that the only hope for a well-functioning takeover market would be a governmental agency with oversight authority. A governmental agency overseeing takeover market, however, was again ruled out by the British government. In July 1967, Prime Minister Harold Wilson insisted that “statutory rules were not the answer”.

6.3.3.1 From Notes to Code plus the Panel

Despite the State’s reassurance of its deferent position, the City interest groups responded swiftly to “put their own house in order”. Once again, mercantile banks inserted their vital influences. In August 1967, following discussions between the Chairman of the Stock Exchange and the Governor of the Bank of England, the Issuing Houses Association reconvened another Working Party, consisting almost exclusively of bankers, lawyers, and institutional investors.

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908 Rule 2.7 Takeover Code.
909 Practice Statement No 20: Rule 2 – Secrecy, possible offer announcement and pre-announcement responsibilities (2008) refers to the ‘particular responsibility of financial advisors for ensuring compliance with Rule 2’ and that the financial advisors should be in control of drafting the announcement.
910 Rule 28 Takeover Code.
911 Rule 16.2 Takeover Code.
915 Kershaw, ‘Corporate Law and Self-Regulation’ in Gordon and Ringe (eds), The Oxford Handbook of Corporate Law and Governance (Oxford University Press 2015)
The results of the Working Party were two: 1) a revised *Notes* which was renamed as the City Code on Takeovers and Mergers (Code); 2) a designated self-regulatory body, the Panel on Take-overs and Mergers (Panel), to enforce the Code. Both results can again be seen as an example of pre-emption by City institutions of potential legislative intervention.916 As the proportion of UK publicly traded companies’ shares held by institutional investors had been growing steadily since the early 1950s, it became the principal policy of the City to nourishing a vibrant but regulated takeover market for the interests of investors, and other City institutions.917

On the one hand, the Code maintained the pro-shareholder spirit as set under the *Notes*, but were in a more specific form to respond to the problematic events that generated pressure for legislative reactions.918 On the other hand, the Panel was established to enforce the will of the City: a representative for the interests of the City; “an informal extension” of the Bank of England.919 In fact, the Panel was chaired by a former Deputy Governor of the Bank of England and staffed by a permanent secretariat provided by the Bank; while its nine members were drawn from the organizations represented on the Working Party.

### 6.3.3.2 Further Empowerment of the Panel

“Agencies are likely to be favourably predisposed to generate new rules, since greater activity tends to justify their existence and increase their power, prestige and budgets.”920 Shortly after its establishment, the Takeover Panel took proactive measures to enforce its authority in dealing with takeover disputes and to ensure its position as the competent autonomous regulator of the takeover market.

The first measure by the Panel was to organize itself by appointing highly reputed persons as its key personnel. Lord Shawcross, a political heavyweight who had formerly been both Attorney-General and President of the Board of Trade, was appointed as the non-executive Chairman; Ian Fraser, an experienced takeover

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917 Ibid
918 Kershaw, ‘Corporate Law and Self-Regulation’ in Gordon and Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2015)
specialist from S.G. Warburg, was recruited as the full time executive Director-General; and Lord Pearce, formerly a Law Lord, was appointed as the President of the Appeal Committee. These appointments increased the Panel’s credibility, ensured a degree of high expertise and practical ability in overseeing the market.\textsuperscript{921}

In addition, a seconded case officer system was deployed by the Panel. Secondees from financial advisory service, including investment banks, financial consulting firms and law firms, would serve in the Panel for a period of time as Takeover Code case officers.\textsuperscript{922} When they return to practice, they have accumulated “valuable human capital wrapped up in their ability to interpret the Code and to predict Panel judgments.”\textsuperscript{923} Their insider knowledge on how the takeover rules works and how the regulators would likely respond to compliance issues can be only appreciated by their clients who seek advices on takeover deals.\textsuperscript{924}

More importantly, sanctioning power available to the Panel are enhanced. In principle, the Panel – a private body – does not possess a direct statutory basis for enforcing the takeover rules. Consequently, it could not enforce the autonomous Code through such statutory mechanisms as fines, injunctions, or ordering the payment of compensatory damages.\textsuperscript{925} To resolve this problem of lack of authority, the Panel created an innovative mechanism called “cold shouldering”, with the endorsement of the City network.\textsuperscript{926}

Under this mechanism, the Panel may issue formal public censures of violators alerting the financial community to the misconduct. Other existing authority or financial institutions in the City would respond accordingly. For examples, the Stock Exchange or the Board of Trade may exercise its power to censure, suspend or expel a censured wrongdoer from the Official List; the banking community or financial intermediaries may refuse to deal with the censured wrongdoer; other trade associations represented in the Working Party may impose internal sanctions upon the

\textsuperscript{921} Ibid
\textsuperscript{922} Kershaw, Principles of Takeover Regulation (Oxford University Press 2016) Para 3.80
\textsuperscript{923} Kershaw, ‘Corporate Law and Self-Regulation’ in Gordon and Ringe (eds), The Oxford Handbook of Corporate Law and Governance (Oxford University Press 2015)
\textsuperscript{924} Ibid
\textsuperscript{925} Rider, ‘Self-regulation: The British Approach to Policing Conduct in the Securities Business, with Particular Reference to the Role of the City Panel on Takeovers and Mergers in the Regulation of Insider Trading’ 1 University of Pennsylvania Journal of Comparative Corporate Law and Securities Regulation 319
censured wrongdoer holding their membership. As proclaimed in the Introduction to a 1981 version of the Takeover Code, the Code:

... has not, and does not seek to have, the force of law, but those who wish to take advantage of the facilities of the securities markets in the United Kingdom should conduct themselves in matters relating to take-overs according to the Code. Those who do not so conduct themselves cannot expect to enjoy those facilities and may find that they are withheld.

The success and endurance of the Panel system has been also a function of the swift and pre-emptive engagement of the Panel to the development in the market for corporate control. The Panel’s function was set to supervise the administration of the Code and to give adjudicative rulings upon application. But the Panel did not stop there. Instead, the Panel perceived that a proactive ex ante involvement was better than a reactive ex post approach to maintain a sustainable takeover market. Its regulatory attitude is active and interventionist: not only the Panel is a supervisory body but also available for transaction-in-progress consultation and advice. This soon became institutionalized as the Panel’s characteristic “real time” guidance in takeover cases.

With these consolidating measures and proactive initiatives, the Panel greatly enhanced its credibility and reputation as the competent regulators of British takeover market. This development quieted the public call for a legislative intervention such as establishing a British SEC. As praised by the market, the operation of newly formed Panel was “outstanding successful by the standards of 1969”. From then on, the UK takeover regime features its independent market controlled regulatory approach and shareholder-oriented spirits.

927 Further discussion is under supra Section 2.2.1.1 The Predominant Role of the Designated Takeover Panel, Chapter 2
930 Rider, ‘Self-regulation: The British Approach to Policing Conduct in the Securities Business, with Particular Reference to the Role of the City Panel on Takeovers and Mergers in the Regulation of Insider Trading’ 1 University of Pennsylvania Journal of Comparative Corporate Law and Securities Regulation 319
931 Christopher Marley, Takeover Panel Sets Standards, Times (London), May 9, 1972
6.3.4 The Spill-over Impacts on the EU Takeover Directive

The political economy and the self-reinforcing effects of this *sui generis* takeover regulatory regime in the UK is also exemplified by the draft and passage of the thirteenth company law directive – the EU Takeover Directive 2004, and its UK' implementation rules.

The Directive, *inter alia*, requires takeovers to be adjudicated by a public authority or other body “recognized by national law.”

932 The Panel, as a self-regulatory organization, ostensibly does not qualify. The UK government, accordingly, placed the Panel on a statutory footing for the first time and transposing the other requirements of Takeover Directive into the Companies Act 2006.

933 Despite this statutory change, the transposition of the Directive was designed to ensure the continuance of the advantages of the autonomous approach. It has only reinforced rather eroded the existing regulatory features of the Panel system.

On the one hand, the transposition of the Takeover Directive has not affected the *modus operandi* of the Panel as the market regulator. The composition of the Panel and the appointment of its members have not appreciably changed. A broad discretionary power is retained by the Panel to update and administer rules governing the conduct of takeovers. Moreover, the Panel, for the first time, is empowered to impose sanctions directly on wrongdoers.

935 On the other hand, the Directive has not required significant changes to the featuring provisions of the Code. The Directive contains both the board neutrality rule and the mandatory bid rule.

936 These are the rules that the Panel, representative of financial institutions of the City, would have been “least likely to alter.” It also contains a provision—the so-called “breakthrough rule”, which was designed to neutralize certain embedded defenses based on differential voting rights.

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932 Article 4, the Takeover Directive 2004
933 Part 28, The UK Companies Act 2006
936 E.g., Section 942, 943, 945, 952 & 955, The UK Companies Act 2006
938 Article 11, the Takeover Directive 2004
In fact, the Directive *per se* is claimed to symbolise the “very essence of the prevailing English capital markets model”. The Directive has evolved from its predecessor, the 1989 proposal, which was initiated by the European Commission in a programme to harmonize company laws across EU member states and to reduce the obstacles to cross-border establishment.

The 1989 Proposal followed the City Code closely and took as its starting point many aspects of the British model of takeover regulation. The Proposal, however, was rejected by the UK government. Firstly, the 1989 proposal did not provide a rulebook as detailed as the City Code; secondly, the 1989 proposal left considerable discretion to member states which render a regulatory vacuum. Most critically, the UK government feared that the mere existence of EU Takeover Directive would create an additional basis which may “meddle with” City’s existing non-statutory regulatory success of the takeover market.

The 1989 proposal is followed by the revised 1996 proposal, which was accepted by the UK. The revised 1996 proposal clarifies that it does not intend to impose extra impact on the UK’s Takeover Panel. It states under article 6.6 that a directive would not affect the law of member states concerning their existing competent authorities. Its Article 4 allows member states to designate a self-regulatory body as supervisory authority. If the designation is made through a statutory instrument, the proposal does not make it necessary to give the body statutory powers so long as its present non-statutory powers are considered sufficient.

As a result, the UK Panel system has fed into the EU Takeover Directive and maintained its distinguished features, in the aspects of regulatory model and the aspects of substantive rules. The UK takeover regime is still an independent and market-controlled system, if not self-regulatory from a strict sense.

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939 Mads Andenas, ‘European Takeover Directive and the City’ 18 Company Lawyer 101

940 Based on Article 54 of the EC Treaty on measures to abolish restrictions on the freedom of establishment.

941 Andenas, ‘European Takeover Directive and the City’ 18 Company Lawyer 101


943 See also Andenas, ‘European Takeover Directive and the City’ 18 Company Lawyer 101
6.3.5 Concluding remarks

To conclude, the British political economy has been the critical source of the self-reinforcing path dependent phenomenon of its takeover regulatory regime. The creation and continuance of the Panel system is a function of the political economy of UK’s takeover market: the hegemonic position of the City and the powerful influence of the City institutions. The interest groups who possess the significant stakes in the regulated market have not been reluctant to exert their power to control the rule-making agenda and to consolidate its predominant status.

6.4 The Political Economy of the Takeover Regulation in the US

As established in chapter 2, the takeover market in the US are currently regulated through a dual structure combining federal securities laws and state corporate law. Federal securities laws, provided under the Williams Act and SEC rules, provide a set of rules addressing takeover procedures, such as shareholder equal treatment, bid timing, information disclosure, and so on. State corporate law, provided under State Anti-Takeover Statutes and case laws, regulates substantive affairs such as who, management or shareholders, has the legitimate power to determine the success of a bid by, e.g., deploying contentious devices known as takeover defences. Under this dual regulatory structure, the US takeover regime features both an anti-takeover spirit and a pro-management approach.\(^\text{944}\)

The following sections set to interpret the above American regulatory features from the perspective of path dependency on political economy context. Three streams of political economy influence could be indentified: the political ideology against concentrated economic power, the federal-states political system, and the influence of powerful interest groups.\(^\text{945}\)


6.4.1 The Macro Political Economic Context: Ideology of Anti-Concentration and Equilibrium of “Strong Managers, Weak Owners”

Historically, the American public has deep mistrust of concentration of accumulated economic power, especially large financial institutions.\footnote{See generally, Scott Bowman, *Modern Corporation and American Political Thought: Law, Power, and Ideology* (Pennsylvania State University Press 2010) Also Roe, “Takeover Politics” in Blair (ed), *The Deal Decade: What Takeovers and Leveraged Buyouts Mean for Corporate Governance* (Brookings Institution 1993)\footnote{“I hope we shall take warning from the example and crush in it’s birth the aristocracy of our monied corporations which dare already to challenge our government to a trial of strength, and to bid defiance to the laws of their country.” Thomas Jefferson to George Logan, 12 November 1816. Full text available at: https://founders.archives.gov/documents/Jefferson/03-10-02-0390, last accessed on 1 August 2017\footnote{Franklin D. Roosevelt, Message to Congress on the Concentration of Economic Power, April 29, 1938}}\footnote{Ibid} This public sentiment can be traced back to American founding fathers like Thomas Jefferson.\footnote{Ibid} Many other politicians have echoed this ideology to oppose the concentration of economic power and accumulated financial control over industry.

Take Franklin Roosevelt as an example. As the President presiding the Great Deal reform, Roosevelt warned that the danger of business centralization in a handful of huge corporations: “Heavy hand of integrated financial and management control lies upon large and strategic areas of American industry…industrial empire building, unfortunately, has evolved into banker control of industry…such control does not offer safety to the investing public…financial controls have taken from American business much of its traditional virility, independence, adaptability, and daring.”\footnote{Franklin D. Roosevelt, *Message to Congress on the Concentration of Economic Power*, April 29, 1938} As the resolution, he proposed: “The power of a few to manage the economic life of the nation must be diffused among the many or be transferred to the public and its democratically responsible government.”\footnote{Ibid}

William O. Douglas, a key bureaucratic actor during the SEC’s formative years and the longest-serving justice in the history of the US Supreme Court, wrote in *United States v. Columbia Steel Co.*: “We have here the problem of bigness…The Curse of Bigness shows how size can become a menace – both industrial and social. It can be an industrial menace because it creates gross inequalities against existing or putative competitors. It can be a social menace – because of its control of prices… price level determines in large measure whether we have prosperity or depression.” Following this observation, he suggested that: “Industrial power should be decentralized. It should be scattered into many hands…It is founded on a theory of hostility to the
concentration in private hands of power so great that only a government of the people should have it.”  

Similar rhetoric has been endorsed by the SEC about financial institutions during the takeover surge in the 1960s. When opposing mutual fund control of portfolio companies, the SEC cited a classical authority supporting the anti-concentration of economic power: “The Congress [in 1890 purporting to end the aggregation of capital by passing the Sherman Act] preferred a system of small producers … [This preference] was based upon the belief that Great industrial consolidations are inherently undesirable, regardless of their economic results.”

The US financial industry is believed to be more stable if fragmented. The policy makers have transposed the political economy ideology against concentrated economic power by restricting private accumulations of power by financial institutions, as exemplified in the destruction of the Second Bank of the United States, the passage of the Sherman Anti-Trust Act and the Glass-Steagall Act, and other Great Deal Reforms.

As a consequence, institutions like banks, insurance companies, mutual funds, and pension funds are either prohibited from controlling large blocks of stock, or so regulated that taking control of large blocks is costly, or so structured that managers of operating companies control their decision-making. Until very recently, the Federal Congress has consistently pursued the fragmentation policy to keep financial institutions “small and separate”. The current Republican government under President Donald Trump has indicated to create a “21st century Glass-Steagall Act” to

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952 United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945)
953 Further discussion in previous chapter 4.
break up big institutions; a proposal supported by both Republican Party and Democratic Party.  

With the separation of the management from the ownership, corporate power was shifted to the professional managers since financial institutions could not hold influential blocks of shares. This situation is translated to the ascendance of managerial control and eventually an equilibrium of “Strong Managers, Weak Owners” for American corporations. Meanwhile, in the absence of institutional shareholders controlling large blocks of stock, the shareholders of public firms are scattered. The dispersed ownership of shares made takeovers, especially those unsolicited, possible. The fragmentation of financial industry set the stage for the takeovers market in the US, its surge in the 1960s and its boom in the 1980s.

Takeovers disrupt the status quo of corporate governance; there are winners and losers after takeover transactions. “Once a group has a benefit… the group subsequently uses politics to maintain and extend that position.” The “Strong Managers” as an influential interest group do not sit idly by in the wave of takeovers which might jeopardize their benefits in controlling American corporations. They reacted swiftly and ferociously by building up antitakeover transactional tactics to fend off unsolicited offers. More importantly, they struck back in the political arena and lobbied legislatures to pass laws that could prohibit hostile takeovers, or could increase transaction costs, or could delay deals long enough to give target management time to maneuver.

In contrast, shareholders, the “Weak Owners” of American corporations, as the potential winners of takeover transactions, faced with the free-rider problem and the collective action problem to counteract the “Strong Managers”. Efficiency gained from takeovers are diffusely distributed among shareholders. They hence have less incentives than managers to assert influence over political arena.

958 Ibid Page 44
Eventually, the managers obtained support, either from the state legislatures or from state judiciary, and beat back the takeover wave, in particular the hostile ones. As a consequence, controlling power in American corporations are consolidated and further entrenched in the hands of the management.\textsuperscript{960} The following sections will discuss how managers affect the state anti-takeover statutes then the state pro-managers case law.

### 6.4.2 The Macro Political Economy Matrix: The Federal – State Relationship

During the hostile takeover boom in the 1980s, many state legislatures adopt state anti-takeover statutes which are in favour of managers to deter takeovers.\textsuperscript{961} The promulgation of these statutes is a function of American federal – state polity and the local state political economy context.\textsuperscript{962} Compared to federal government, the local state governments are more concerned with the disruptive and detrimental effect of a takeover transaction on collateral interests of local employment, community, suppliers.\textsuperscript{963}

As spelt out in the Preamble to the ratified North Carolina Shareholder Protection Act 1987, the amended anti-takeover statute was a regulatory response to the increasingly frequent takeover bids or takeover attempts targeting corporations in North Carolina. The policy maker is convinced that the takeover activities “highly disruptive to communities within North Carolina by causing, among other things, high unemployment and erosion of the State and local economy and tax base”.\textsuperscript{964} Because corporations in the North Carolina offer large employment and pay significant

\textsuperscript{960} Roe and Vatiero, ‘Corporate Governance and its Political Economy’ in Gordon and Ringe (eds), The Oxford Handbook of Corporate Law and Governance (Oxford University Press 2017) <Available at SSRN: http://ssrn.com/abstract=2588760 or http://dx.doi.org/10.2139/ssrn.2588760>

\textsuperscript{961} Detailed discussion on the above chapter 2.

\textsuperscript{962} There are at least five “standard” types of anti-takeover statutes: control share acquisition statutes; fair price statutes; business combination statutes; poison pill endorsement statutes; and constituency statutes. Each of the standard anti-takeover statutes has been adopted in a majority of the states. Arye Bebchuk and Ferrell, ‘On Takeover Law and Regulatory Competition’ (2002) 57 Business Lawyer 1047 Roe, ‘Capital Markets and Financial Politics: Preferences and Institutions’ (2012) 7 Capitalism and Society 1


amounts of taxes, North Carolina government has a “vital interest in providing to these corporations the benefits of the provisions” under a new anti-takeover law.

Anti-takeover statutes such as the North Carolina anti-takeover law immunize target managers of the home states from unsolicited takeovers by, in particular, out-of-state raiders. They are enacted mostly at the prompting of management as influential local in-state business leaders in response to real takeover events. The in-state business leaders have the strength of their lobbying organizations (such as Chambers of Commerce, the Business Roundtable of other industry associations) in influencing local state legislatures. In contrast, out-of-state institutions are more dispersed than in-state targets and less influential in the state. “Local politicians respond first to their constituents, the in-state targets, not to the out-of-staters.”

6.4.2.1 Minnesota as an example

One example is the enactment of the Minnesota anti-takeover statute. On June 18, 1987, Dayton Hudson, based in Minnesota, found that the Dart Group Corp., based in Maryland and controlled by Washington’s Haft family, had been aggressively buying Dayton shares. Feared of an impending takeover bid, Dayton’s chairman, Kenneth A. Macke, urged Minnesota Governor Rudy Perpich (D) to call an emergency session of the state legislature to adopt a new law to deter Dart or other potential buyers from taking over any Minnesota company.

Dayton, the then seventh-largest retailer company in the US, had great political and economic influence in the state of Minnesota. It was the largest company in Minnesota in terms of revenue – $9.3 billion, and employment – 34,000 workers.
The company “is like God and motherhood” for Minnesotan. To push for its antitakeover bill in the state congress, Dayton, among other measures, hired the top five lobbying firms in the state of Minnesota, and turned out its employees in a massive letter-writing campaign to impose pressure on the policy makers.

Dayton’s initiative rooted in Dayton Hudson’s political clout in its home state turned out to be a great success. The Minnesota state government responded very fast. In the morning of June 25, just seven days after Dayton asked the state to tighten its takeover laws, Minnesota’s House of Representatives voted 120-5 to adopt a stringent anti-takeover legislation. Minutes later, the state Senate unanimously passed the measure and sent it to Governor Perpich, who signed the emergency legislation on the same day.

The new anti-takeover law codified a number of defensive measures, which made it much costlier for the acquirements of target companies based in Minnesota. For example, it barred the acquirer from selling the target company’s assets for at least five years after the takeover. This would make it much harder for corporate raiders to finance any acquisition because they could not use the target company’s assets to pay off the leveraged debt. In addition, shareholders of the target company were given the right to vote on whether any shareholder can vote more than 20 per cent of the company’s stock. This would make it much more difficult for the raiders to exercise its majority ownership position to replace the incumbent management to obtain the control of the company.

6.4.2.2 Connecticut as another example

Connecticut anti-takeover statute 1984 share another similar legislative journey. The Connecticut statute requires, inter alia, business combinations with interested shareholders (ten percent owners) to be approved by super majority vote (eighty percent plus two-thirds disinterested shares). This requirement could only be exempted, either when the transaction is approved by a disinterested board, or the


terms of the transaction is equal to the current market price or the highest price the
interested party paid for its shares, whichever is higher. As the result, takeover
transactions in Connecticut becomes prohibitively costly, if not infeasible.

It has been well documented the Connecticut law was adopted at the behest of a single
politically powerful corporation in Connecticut, the Aetna Life and Casualty
Insurance Company (Aetna). Aetna has considerable influence in state politics of
Connecticut. Widely perceived as a “first class local corporate citizen”, Aetna was
one of eighteen NYSE corporations incorporated in Connecticut. It was second largest
publicly-traded Connecticut companies ranked by sales, with assets valued at
approximately $44 billion, sales of approximately $14 billion, and profits of
approximately $427 million.

In addition, the Aetna enlisted the support of the most important business association
in the state, the Connecticut Business and Industry Association (CBIA). The CBIA is
the largest representative organization for business firms in Connecticut. Essentially
the state chamber of commerce, the CBIA has a membership of over 6,000
Connecticut businesses. Major corporations in the state, including Aetna, are
represented on the managing board.

The CBIA is also the largest lobbying organization in Connecticut. It is the perennial
leader in putting financial resources into its lobbying efforts. For example, in 1984,
the year the takeover statute was enacted, the CBIA spent around $250,000 on
legislative lobbying. This expenditure is substantial in relative terms: the second
highest level of lobbying expenditures by a utility company was only slightly more
than $70,000. Given its ability to allocate considerable funds for lobbying, the
CBIA is a powerful force in Connecticut political economy context.

Indeed, both Aetna and the CBIA lobby extensively for the new law. According to
reports filed with the Connecticut State Ethics Commission for 1984, both Aetna and
the CBIA took several legislators out to dine in February and March of 1984. In

976 Jonathan R. Macey, ‘State Anti-Takeover Statutes: Good Politics, Bad Economics’ Wisconsin Law Review 467
977 Resa W. King and Marc Frons, ‘How Government Groomed Jim Lynn for Aetna’ Business Week
978 Romano, ‘The Political Economy of Takeover Statutes’ (1987) 73 Virginia Law Review 111 Footnote 36 and
accompanying text.
addition, Aetna’s chairman hosted a buffet in May for the leading politicians in the state. In the late 1984 legislative session, the new law was passed by both houses of Connecticut, and signed by the governor in approximately two months.

The political and economic influence of local firms such as Dayton in Minnesota or Aetna in Connecticut could also be found in many other states. In July 1987, Greyhound, an Arizona company, feared a takeover and got a special session of the Arizona legislature to pass an antitakeover bill. One year later, when Citizens & Southern National Bank, a Georgia bank, became a target in the same year, the bank’s representatives convinced the Georgia legislature that state corporate law ought to allow directors to weigh effects on corporate constituencies.

Other examples include Armstrong World Industries sought legislative support from Pennsylvania, Arvin Industries from Indiana, Boeing Industries from Washington, Burlington Industries from North Carolina, G. Heileman Brewing from Wisconsin, Gillette from Massachusetts, Goodyear Tire and Rubber Company from Ohio, Greyhound from Arizona, Harcourt Brace Jovanovich from Florida, to name a few.

When “management turned to the state legislature, politics trumped markets.” These provisions have wide-ranging implications for American corporate governance and takeover market. The surge and boom of takeovers market by the early 1980s beacons a potential shift of corporate controlling power in the US from managers to shareholders and the takeover entrepreneurs. But American political economy context renders strong path dependency reinforcements of the management as a powerful interest group. By calling for local political support, managers won state-by-state the takeover battles with the anti-takeover legislation. Consequently, the equilibrium of

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979 Ibid Footnote 43 and accompanying text.
983 Ronald J. Gilson, ‘Takeover Politics - Comment by Ronald J. Gilson’ in Margaret M. Blair (ed), The Deal Decade: What Takeovers and Leveraged Buyouts Mean for Corporate Governance (Brookings Institution 1993)
“strong managers, weak shareholders” is further entrenched regarding to its takeover market.  

6.4.3 The Micro Political Economy Interest Groups: Delaware state, lawyers and others

Chapter 4 examined the original conditions which contributed to the ascendance of Delaware case law to be the primary authoritative source of takeover rules in the US. Since then, Delaware courts have developed a standard based regulation in dealing with substantive takeover disputes. Among others, directors of target companies have a wide breadth of discretionary power under the corporate fiduciary duties. When adopting defensive measures, they need only to prove that they possessed reasonable grounds for believing a threat to corporate policy and effectiveness existed and that the defensive measure used to be reasonable in relation to the threat posed.

Delaware’s standard based pro-management regulation is contingent on a combination of unique political economic context. The following part will examine the sui generis political economic context by focusing on a nexus of interest groups that provide and benefit from the state’s incorporation status: Delaware State’s interests in revenue; the bar association interest in advising corporations in Delaware; and the interests of other constituencies.

6.4.3.1 The Revenue Driven Government

The State of Delaware is both small and big. It is small as it is the second smallest and the sixth least populous state in the US. It is big as in the realm of US corporate governance Delaware is the leading jurisdiction for publicly traded corporations listed on US stock exchanges. More than half of these companies, among which 64% are Fortune 500 companies, are incorporated in Delaware. These corporation and new incorporations contribute several hundred million dollars annually to the Delaware state’s budget. Given the small size of the Delaware, the corporate franchising income

985 Further discussion on the Delaware case law is under previous chapter 2
987 Delaware Corporate Law, Facts and Myths: http://corplaw.delaware.gov/facts-and-myths/#fn:1, Last accessed on 1 June 2017
constitutes from fifteen per cent to one-quarter of the revenue income of the Delaware. To maintain a substantial inflow of incorporation franchise fees hence become the raison d'être behind the whole system of Delaware corporate governance.988

When takeover boom picked its tide in early 1980s, Delaware policy makers observed that their state’s dominant market share of incorporation business could be threatened by other states. The main reason was that, comparatively, Delaware incorporated companies were more vulnerable to takeover raids. On the one hand, Delaware by that time did not have a stringent anti takeover statute; on the other hand, Delaware court opinions were not sufficiently pro management in the wake of takeover boom. Companies were urged to consider an exodus from Delaware for a more hospitable state for their management. States like “New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era.”989

Compared to other states, the franchise tax dollar to Delaware is substantially critical than any other state. “When a corporation is thinking of transferring to Delaware, for example, but instead has gone to Maryland, the [Delaware] state officials begin thinking of the franchise dollars.”990 For example, the then Governor Michael Castle (GOP) suggested that the “$188 million annual revenue from corporations —18 per cent of the state’s total revenues — is in danger because of competition from other states if Delaware does not protect its corporations the way other states have.”991

Delaware would not let its premier position in American corporate law go by default. The first initiative to reinforce its position is to join the “anti takeover bandwagon” and amended the existing corporate law rules to be more favourable to management. In 1976, Delaware passed its first anti takeover statute, regulating tender offers by, among other things, requiring pre offer notice.992

992 The statute was also codified at § 203. See DEL. CODE ANN. tit. 8, § 203 (1986).
The first takeover legislation was subsequently repealed in 1987. One year later in 1988, a so-called “business combination” Act was enacted as Delaware’s second-generation anti-takeover statute.\textsuperscript{993} The new statute imposed a “cooling-off” period of three years on any party holding 15\% or more of the voting stock in a publicly-traded Delaware corporation. Within the specified period, the concerned party is prohibited from engaging in any business combination with the corporation without prior approval from directors of the corporation.\textsuperscript{994}

\textbf{6.4.3.2 The Sophisticated Judges}

The new anti-takeover statute greatly enhanced the power of the management. Nevertheless, the anti-takeover statute is neither exclusive nor definitive for Delaware corporations concerning the propriety of takeover defences. As discussed in the previous chapter 2, Delaware regulatory institutions of takeover market features a highly specialized and well-regarded judiciary system. The full function of the new anti-takeover statute relies on the courts, where sophisticated judges define the parameter of the Delaware statute and adjudicate the behaviour of market participants under the statutory provisions.\textsuperscript{995} Through various decisions in the takeover context, the Delaware courts provide guidance to directors concerning their obligations of due care and loyalty in the consideration of proposed acquisitions. This body of case law solidly established the pro-management spirit of takeover rules in Delaware.

Take the poison pill defensive mechanism as an example. Poison pills can be a show-stopper to takeover deals; they are in particular effective to ward off an unsolicited tender offer. In fact, no company has ever been acquired when a flip-in pill was in place.\textsuperscript{996} Flip-over pills function similarly, except that they do not stop a raider who is willing to acquire majority ownership and forgo a subsequent freeze-out merger.\textsuperscript{997} As

\begin{itemize}
\item \textsuperscript{993} \textit{DEL. CODE ANN. tit. 8, § 203 (1988)}
\item Similar acts could be found in many other states, including: Arizona, Connecticut, Georgia, Idaho, Indiana, Kentucky, Minnesota, Missouri, New Jersey, New York, Pennsylvania, Washington and Wisconsin.
\item See \textit{DEL. CODE ANN. tit. 8, § 203 (1988)}.
\item A flip-in pill has been triggered only once, and that did not occur in the context of a hostile takeover. \textit{See} Mark D. Gerstein et al., Latham & Watkins, LLP, Lessons from the First Triggering of a Modern Poison Pill: Selectica, Inc. v. Versata Enterprises, Inc., 1-5 (Mar. 2009), http://www.lw.com/upload/pubContent/_pdf/pub2563_1.pdf (noting that the pill at issue was designed to protect Selectica’s net operating losses, rather than to protect it against a hostile bid, and was triggered by Versata Enterprises to obtain leverage in an unrelated business dispute).
\item This was illustrated by James Goldsmith’s takeover of Crown Zellerbach in 1985. \textit{See} Jonathan P. Hicks, \textit{Goldsmith Wins Control of Crown Zellerbach}, N.Y. TIMES (1July 26, 1985), http://nyti.ms/1OQMVlz.
\end{itemize}
summarized by Martin Lipton: “[The poison pill] is an absolute bar to a raider acquiring control . . . without the approval of the company’s board of directors.”

The case law development mainly started in 1985 through 1989, when the Delaware Supreme Court validated poison pills in several decisions. In Moran, the court upheld the use of flip-over poison pills. In Unocal Corp. v. Mesa Petroleum Co., the court sanctioned a self-tender offer that involved discriminatory treatment equivalent to that caused by flip-in poison pills. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., the court commented favourably on the board’s use of a precursor to a flip-in poison pill — which discriminated between a raider and other shareholders — to induce a raider to increase its offer price. And in Paramount Communications v. Time Inc., the court held a pill could be used indefinitely to “just say no” to hostile offers.

6.4.3.3 The Resourceful Lawyers

Maximizing state tax revenue is not the only driving force behind Delaware’s efforts to reinforce Delaware as the favorable state for corporations. Other interest groups especially the politically powerful lawyers and their bar association are also beneficiaries of corporate chartering in the Delaware. Their capital and knowledge investment have been locked-up in their advisory service businesses in Delaware and cannot easily be reallocated elsewhere without significant economic loss. Maximizing lawyers’ interests become another political economy force behind the reinforcing movement to uphold Delaware’s position as the primary provider of pro-management takeover law in the US.

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999 Detailed discussion about these cases is under previous chapter 2.


1001 Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946 (Del: Supreme Court, 1985).


1003 Paramount Communications, Inc. v. Time Inc., 571 A. 2d 1140 (Del: Supreme Court, 1989).


Lawyers in Delaware are successful in transforming Delaware’s competitive advantage into their own profits. They enjoy significant advantages in organizational structure as well as economies of scale in obtaining information about the effects of changes in Delaware law on the demand for corporate charters and legal services.\textsuperscript{1006} Their political power can be seen in the way Delaware’s corporate law is produced. Delaware lawyers experienced in corporate law have historically have staffed the Delaware legislature’s drafting committees.\textsuperscript{1007}

Take the Delaware Law Revision Commission of 1967 for one example. The Commission was organized by the then Secretary of State as an initiative to reinforce the Delaware’s leading position in incorporation market. It has the mandate to ascertain, \textit{inter alia}, what other states but Delaware have to attract incorporations; how should Delaware reform its corporate law to attract more incorporations.\textsuperscript{1008}

The chairman of the Commission was the late C. A. Southerland, who served for twelve years as the chief justice of Supreme Court of Delaware and was later counsel to one of the leading firms in Delaware. The other members consisted of: one delegate from the plaintiffs’ bar; three senior partners of leading firms in Wilmington, one of whom resigned to join the Delaware Supreme Court; one representative of the Corporation Trust Company; and the president of the U.S. Corporation Trust Company of New York.\textsuperscript{1009}

With prominent peers occupying such responsible roles in public service, lawyers in Delaware link the nexus between the legislative process and the judiciary decision. The nexus could be further illustrated, as documented by William L. Cary, by comparing the members of the Delaware Law Revision Commission of 1967 with the justice of the Supreme Court of Delaware up until late 1970s.\textsuperscript{1010} The following table 6.1 compares this Commission with the background of the seven justices of the Supreme Court from early 1950s to late 1970s.

Table 6.1, Justices of the Supreme Court of Delaware 1951 - 1973

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
Year & Justice Name \\
\hline
1951 & Justice A \\
\hline
1952 & Justice B \\
\hline
1953 & Justice C \\
\hline
1954 & Justice D \\
\hline
1955 & Justice E \\
\hline
1956 & Justice F \\
\hline
1957 & Justice G \\
\hline
1958 & Justice H \\
\hline
1959 & Justice I \\
\hline
1960 & Justice J \\
\hline
1961 & Justice K \\
\hline
1962 & Justice L \\
\hline
1963 & Justice M \\
\hline
1964 & Justice N \\
\hline
1965 & Justice O \\
\hline
1966 & Justice P \\
\hline
1967 & Justice Q \\
\hline
1968 & Justice R \\
\hline
1969 & Justice S \\
\hline
1970 & Justice T \\
\hline
1971 & Justice U \\
\hline
1972 & Justice V \\
\hline
1973 & Justice W \\
\hline
\end{tabular}
\end{table}
Almost all the justices in this period were drawn from the group responsible for the 1967 revision of the corporation law. And a majority of the justices practiced law in the firms which represent the important corporations registered in Delaware. Justices Southerland and Wolcott had been partners in a distinguished firm. Justice Tunnel eventually joined another, and Justice Herrmann was the senior partner of still another bearing his name. Three left the bench, two of them to return to leading firms in Delaware, and one to become Governor. With the exception of Justice Carey, who

served from 1945 on the bench in various roles, all but two of the justices have been directly involved in major political positions in the state. 1011

As in the old days, at the present time the justices of the Delaware Supreme Court and the Court of Chancery are drawn predominantly from law firms that represent corporations registered in Delaware. (Table 6.2 & 6.3)

Table 6.2, Current Justices of Delaware Supreme Court

<table>
<thead>
<tr>
<th>Justice</th>
<th>Previous background</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chief Justice Leo E. Strine, Jr.</td>
<td>a corporate litigator at Skadden, Arps, Slate, Meagher &amp; Flom</td>
</tr>
<tr>
<td>Justice Randy J. Holland1012</td>
<td>a partner at Morris, Nichols, Arshe &amp; Tunnell</td>
</tr>
<tr>
<td>Justice Karen Valihura</td>
<td>a partner at Skadden, Arps, Slate, Meagher &amp; Flom</td>
</tr>
<tr>
<td>Justice James T. Vaughn, Jr.</td>
<td>Vaughn &amp; Vaughn; Schmittinger &amp; Rodriguez in Dover</td>
</tr>
<tr>
<td>Justice Collins J. Seitz, Jr.</td>
<td>a partner of Connolly Bove Lodge &amp; Hutz; a partner of Connolly Bove Lodge &amp; Hutz LLP in Wilmington Delaware</td>
</tr>
</tbody>
</table>


Table 6.3, Current Justices of Delaware Court of Chancery

<table>
<thead>
<tr>
<th>Justice</th>
<th>Private practice background</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chancellor Andre G. Bouchard</td>
<td>a corporate litigator in the Delaware office of Skadden, Arps, Slate, Meagher &amp; Flom.</td>
</tr>
<tr>
<td>Vice Chancellor J. Travis Laster</td>
<td>a director in the Corporate Department of Richards, Layton &amp; Finger P.A.; a founding partner of Abrams &amp; Laster LLP1013</td>
</tr>
<tr>
<td>Vice Chancellor Sam Glasscock III</td>
<td>an associate at Prickett, Jones, Elliott, Kristol &amp; Schnee</td>
</tr>
<tr>
<td>Vice Chancellor Tamika Montgomery-Reeves</td>
<td>a partner in the Wilmington, Delaware office of Wilson Sonsini Goodrich &amp; Rosati; Weil, Gotshal &amp; Manges LLP in New York</td>
</tr>
<tr>
<td>Vice Chancellor Joseph R. Slights III</td>
<td>a partner in the Delaware law firm Morris James LLP; a litigator in the Delaware law firms Sidney Balick PA and Richards, Layton &amp; Finger PA.</td>
</tr>
</tbody>
</table>

1011 Ibid
1012 Justice Holland stepped down from the Bench on March 31, 2017.
1013 A corporate law boutique specializing in high stakes litigation involving Delaware corporations and other business entities, and advising on transactional matters carrying a significant risk of litigation.
The Nexus of Politicians, Judges and Lawyers

It is therefore unsurprising that Delaware state politicians and lawyers inevitably would align the judiciary solidly with Delaware legislative policy. Delaware well-intentioned judges would believe that the state judicial system well serves Delaware corporations; with Delaware’s corporate lawyers play an active role in corporate affairs. Delaware judges can be expected to develop common law requiring that Delaware lawyers be consulted when important decisions are to be made. This judicial temperament supplements the interests of the Delaware bar of “achieving the legal environment that maximizes demand for its services.”

Companies need legal opinions about Delaware law and need lawyers to litigate disputes. Lawyers could do best if the legal system followed a mixed strategy of clearly articulated standards that can only with difficulty be applied to the facts of any specific controversy. Lawyers could articulate a clear rule but would need a court to resolve its uncertain application to complex factual environments. Take the poison pill defensive initiative again for an example.

Invalidating the use of a poison pill is a clear pro-takeover standard but does not require lawyers’ legal service. While validating the pill in all instances is a clear anti-takeover standard but also needs little lawyers’ service. To maximize lawyers’ revenues, the best approach is to validate the poison pill as a default practice, as it was validated in Moran, but then subjecting it to a judicially reviewable proportionality standard, under which the courts, aided by lawyers, determine whether a board should yank the pill in the face of a particular offer. This approach, adopted by the Delaware courts, would generate a lot of lawyers’ billing hours, or, service fees.

might attract corporations, but lawyers also gain from wobbling, uncertainty, and instability”, which enhance the chance, length, and legal fees of a takeover battle.\footnote{1016}

6.4.4 Concluding remarks

“Takeover cannot be fully understood without understanding the role of American politics.”\footnote{1017} As in the UK, the US regulatory choices regarding takeover market depend on American political economy context: the ideology of anti-concentration of economic power, the federal – state polity, and the nexus of interest groups in local states.

Political pressure and public dislike of private economic concentration influenced politics to favour small financial institutions and reinforced small financial institutions’ dominance in American capital market. Without large institutional investors in place, managers were left in control of American companies. The Federal – State polity made important local state politics. It led to the takeover laws’ being made in the states, in particular Delaware, and magnified the power of local interest groups. Consequently, managers and other market participants including lawyers become powerful interest groups in making American’s standard based pro-management takeover regulation.\footnote{1018}

Conclusion

The legal evolutionary path is dependent of many variables. The previous Part II has discussed how the original conditions set the foundation for the takeover regimes in the UK, the US and China. This part examines another key driving force: the influence of political economy.

Since their establishment in the late 1960s, regulatory heterogeneity over takeover markets has remained in the UK and the US. This chapter discusses how the divergent features have been reinforced under a variety of political economy determinants: ideology, polity, interest groups. These determinants have strengthened the pre-existing system and consolidate the evolutionary path.

\footnotetext{1016}{Ibid}
\footnotetext{1017}{Ibid}
\footnotetext{1018}{See also Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (Princeton University Press 1994) Page 27}
In the UK, the political economy determinants manifest themselves with a confirmation of the laissez-faire ideology, the City – State polity, combined with the financial intuitions’ embedded position. This conformation has entrenched the UK Panel system, which features a market controlled independent regulatory regime in favour of a shareholder primacy approach. The UK Panel system have persisted in the second half of the twentieth century and in the early twenty-first century, and that it will continue into the foreseeable future.\textsuperscript{1019}

In the US, it is the anti-economic concentration ideology, the Federal – State polity, and the powerful interest groups including managers and lawyers in the local states that have dominantly influenced the evolutionary path of the dual-structure regime. The states, in filling the regulatory void left by the federal government, have created a landscape of piecemeal state takeover laws, statutory provisions and judicial rulings, that features a pro management spirit. The takeover regulatory pattern will continue to reflect the political economy equilibrium in the US.\textsuperscript{1020}

“Laws set the rules for corporate takeovers, and politics influenced what laws were made.”\textsuperscript{1021} The next chapter 7 will endeavour to examine the connections between China’s takeover regime and the embedded political development and economic reform context.

\textsuperscript{1019} See also Talani, \textit{Globalisation, Hegemony and the Future of the City of London} (Palgrave Macmillan 2012) Page 203
\textsuperscript{1020} See also Jonathan R Macey, ‘The Politicization of American Corporate Governance’ (2006) 1 Virginia Law and Business Review 10
Chapter 7: The Political Economy of Takeover Regulatory Regime in China

Introduction

To understand the underlying factors shaping the regulatory regime of the Chinese takeover market, chapter 5 analyses the initial conditions of the Chinese legal system from the legal origins perspective. The analysis reveals strong elements of continuity of regulatory patterns. On the one hand, the characteristics of China’s legal system, such as the predominant administrative regulation, the subordinate judiciary power, the use of policy as the guiding light behind laws, and the reliance on extrajudicial dispute settlements, have persisted and penetrated into the regulation structure; on the other hand, substantive takeover rules feature “shareholders centralism” in allocating corporate decisional powers to shareholder meetings as the “supreme” decision-making organ of a company. 1022

How then shall we conceptualize the rather complex processes of persistence of these features? What direction China’s takeover regulatory regime is likely to take in the future? To answer these questions, this chapter turns to the enhanced self-reinforcing path dependency theory from the political economy perspective.

This chapter examines China’s political economy ecology and analyses its impact on China’s takeover regulatory regime by focusing on three main aspects: the Party – State governance system, the corporate ownership reform, the securities market development. The primary purpose is to test one of the hypotheses as proposed in Chapter 1, namely, the takeover regulatory regime in China has demonstrated lock-in effects due to the self-reinforcing path dependence phenomenon caused by China’s unique political economy ecology.

The Party-State is the most important factor within China’s political economy ecology. The Party, i.e., China’s Communist Party or CCP, as Chairman Mao proclaimed, is

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1022 Article 8 & 33, Takeover Measures 2014; Article 37 & 99, Companies Act 2014. Further discussion is found in chapter 3.
“the leader of all” in China. It has a ubiquitous institutional presence in the governmental structure of the China’s polity. The Party has a self-serving political economy objective to maintain itself as the monopolistic control of the State and the society. The objective determines the general policy orientation toward the reform of State-owned enterprises and the development of the securities market, which constitutes the backdrop of takeover market and regulations.

7.1 Party – State Governance System

The CCP has been the sole ruling party in mainland China since 1949. Under the current constitutional framework, the CCP is the holder of “supreme collective political authority”. The CCP imposes the paramount leadership and ubiquitous influence on every aspect of Chinese society. Its hegemonic status is enshrined in the current Chinese constitutional framework.

7.1.1 The Constitutional Framework

The current Chinese constitutional framework is comprised of two fundamental documents: the Constitution of the China and the Charter of the CCP. The Chinese Constitution sets out the organization of the state, the relationship between the state apparatus and the party in power. The Constitution prescribed China as a one-party state, in which the CCP is defined as the perpetual leader for the State and the nation. Among others, it is stressed that:

The Chinese people led by the Communist Party of China with Chairman Mao Zedong as its ultimate leader, in 1949, overthrew the rule of imperialism, feudalism and bureaucratic capitalism, won the great victory of the new-democratic revolution and founded the People’s Republic of China...

The Chinese people will continue adhering to the leadership of the Communist Party of China to…develop a socialist market economy ... improve the socialist legal system...

Meanwhile, the Charter of the CCP reaffirms the Party’s hegemonic position within the State’s political system. The Party is the “core of leadership for the cause of socialist modernization” in China.\textsuperscript{1027} The Charter stipulates that the Party leads the nation in every front of development, including, \textit{inter alia}, developing the socialist market economy; promoting the socialist democracy; building a harmonious socialist society.\textsuperscript{1028}

This hegemonic position of the CCP within the Chinese political economy system is reassured in the most recent \textit{Resolution of the 19th National Congress of the Communist Party of China on the Revised Charter of the Communist Party of China}:\textsuperscript{1029}

\begin{quote}
The Congress holds that the leadership of the Communist Party of China is the most essential attribute of socialism with Chinese characteristics, and the greatest strength of this system; the Party exercises overall leadership over all areas of endeavour in every part of the country.
\end{quote}

Firmly reinforced in these constitutional documents, the political economy ecology in China is inextricably linked to a symbiosis of Party-State governance structure. The Party-State governance denotes “the nature of the Chinese government” and captures the country’s “political reality”.\textsuperscript{1030} As pointed out by Yongnian Zheng,\textsuperscript{1031}

\begin{quote}
The relationship between Party and the state (government) is the most important aspect of the Chinese political system.
\end{quote}

China’s State-Party governance structure \textit{per se} demonstrates the effects of a path dependency dynamics. As a political concept and reality, it was first proposed and

\begin{flushright}

\textsuperscript{1028} Other developments are leading the nation in promoting socialist ecological progress, in developing an advanced socialist culture. General Programme, The Charter of CCP 2012.


\textsuperscript{1030} See also Xi Jinping’s Report to the 19th CCP National Congress on October 18, 2017. http://news.ifeng.com/a/20171027/52825234_0.shtml. Last accessed on October 28, 2017


\end{flushright}
practiced not by the CCP government but by the previous Nationalist Government (1911 - 1949), as formed by the Nationalist Party (also known as the KMT). In 1931, the Nationalist Government enacted the Tutelary Period Provisional Constitution of the Republic of China. The Provisional Constitution incorporated fundamental principles such as a “party construction of the state,” “party rule of the state,” and “party above the state.” Among others, the article 30 specifies that during the Tutelary Period, the KMT represents the National Conference to direct and supervise the National Government.

After taking control of the central government from the KMT in 1949, the CCP inherited the Party-State governance system. Since then, the CCP as the ruling party has projected its hegemony over the machinery of the State through three main directions: ideological leadership, political leadership, and organizational leadership. The hegemonic position of the Party over the State in the past 70 years had not changed; in fact, the degree of its control only gets stronger and stronger. For example, the frequency of the term “leadership” of the Party has become much higher in the recent Party Secretary’s reports to the CCP National Congress which is held every five years. (Figure 7.1)

Figure 7.1 Frequency of the Term “Leadership” in the Last Five General Secretary’s Reports to the CCP National Congresses

1033 Xu Juhua, Jiang Jieshi Chenbai Lu [A Record of Jiang Jieshi’s Success and Failure] ch. 12.
1035 General Program, Constitution of the Communist Party of China, 2017

7.1.2 The Party – State’s Macro Control of Law and Policy

In the macro political arena, the Party hegemony results in the mixture of the Party policy and the State legislation. The will of the CCP and its corresponding policies plays a decisive role in leading the law-making activities of the state. The CCP carries the mission to identify and articulate political tasks, political objectives, and political directions for state development. Derived policies of the CCP are the foremost source of norms regulating all aspects of state and society ranging from important political arrangements of the State to economic operation of the society.

The law is perceived as an instrument of Party policy to facilitate social and economic development. In other words, State law constitutes the mature form of Party policy while Party policy as the foundation of State law. As such, the nature and the

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1037 Xiaodan Zhang, ‘Rule of Law Within the Chinese Party-State and Its Recent Tendencies’ (2017) 9 Hague Journal on the Rule of Law 373
1040 Instrumentalist this attitude might be, but as he himself was twice the victim of the lawless days, Deng was different from Mao in one crucial respect: he and the Party under his leadership saw law as a better tool than policy, capable of securing and institutionalising ad hoc policies in a more universal manner, of providing stability and order through state coercive forces for economic development, and of defining rights and duties in relation to the state as represented by various administrative authorities. Chen, Chinese Law: Context and Transformation (Martinus Nijhoff Publishers 2008)
extent of legal development fundamentally depends on the parameters set by the political economy reform program.\textsuperscript{1042}

The phenomenon has been entrenched in recent years. Since 2012 with the consolidation of Xi’s leadership within the CCP, much of the government’s power has been substantially taken over by the Party. The Party has not only engaged in conventional strategic policy making endeavours, but also undertook rule making activities governing many concrete matters.\textsuperscript{1043}

Take the Party’s \textit{Central Leading Group for Comprehensively Deepening Reforms} for example. The Leading Group was established in November 2013 pursuant to the decision of the 3rd Plenary Session of the 18th Central Committee of CCP. The Leading Group’s chairperson is the Party’s general secretary and State’s president; its four vice chairpersons includes the premier and two deputy premiers of the State Council, and the first-ranked secretary of the Secretariat of the CCP’s Central Committee. There are additional twenty members from both the Party and the State organs.\textsuperscript{1044}

The Group now makes comprehensive decisions on most important political, economic and social issues.\textsuperscript{1045} It has held 39 meetings since its first inauguration meeting in January 2014. These meetings have issued more than 200 binding documents. For example, the recent Group meeting held on 20 November 2017 has issued 17 documents on issues ranging from State legislative process, State owned enterprises reform, environmental protection, intellectual property protection, urban development and education system reform.\textsuperscript{1046}


\textsuperscript{1045} Zhang Yunbi, ‘Leading Group's focus is to deepen reform’ (China Daily, October 17, 2017) <http://www.chinadaily.com.cn/china/19thcpcnationalcongress/2017-10/17/content_33352410.htm> accessed 25 November, 2017

This Party leadership in policy/law making is embodied not only in the direct binding force of CCP policies, but also in the flourish of the administrative law-making by the State Council, and its subsidiary departments/ministries. Pursuant to the constitutional framework, the State Council primarily is an executive organ with limited designated legislation power. However, under the Party – State governance structure, the Party has exclusive control over the State Council, which makes the latter to be “an easy-to-use tool” for the Party to implement its will and policies.\textsuperscript{1047}

The administrative regulations are similar to the CCP’s policies or guidelines. Both feature much simpler and more flexible rules making process compared to the legislation as promulgated by the National People’s Congress (NPC).\textsuperscript{1048} As a result, in contrast to the standstill of the legislative work of the NPC and its Standing Committee as constitutional legislative organs of the State, the administrative law making by the State Council and its subsidiary departments remains very active. Administrative regulations are much more prevalent than laws as promulgated by the legislative organ.

The China’s takeover regime evidently manifested this feature. As we have seen in previous Chapter 3, the regulation framework is dominated with administrative rules as produced by the State Council, and its designated securities market regulator – the CSRC.\textsuperscript{1049} Indeed, the primary legal resources, namely, the Takeover Measures, is an administrative regulation released by the ministry level entity, namely CSRC.

**7.1.3 The Party – State’s Micro Governance in Corporate Organization**

In organizational arena, the Party holds one most significant power as embodied in the *nomenklatura* system, known as “Party management of cadres”.\textsuperscript{1050} Essentially, this is

\textsuperscript{1047} Zhang, ‘Rule of Law Within the Chinese Party-State and Its Recent Tendencies’ (2017) 9 Hague Journal on the Rule of Law 373

\textsuperscript{1048} Ibid

\textsuperscript{1049} For further discussion on the regulation structure of takeover transaction in China, please refer to Chapter 3


a system of maintaining lists of leadership positions through which the Party monopolistically exercises its personnel power. It is “the most important organizational pillar [in the Chinese political system], which gives the CCP a dominant say over personnel decisions of all important positions”.1051

The Party, through its organizations at various levels, directly exercises power to appoint or remove, promote or demote individual Party members to/from key decision-making positions in institutions, such as governmental organs, economic enterprises, and other social entities.1052 The Party’s micro control in personnel appointments is particularly manifested in the SOEs. It is documented that in the national SOEs nearly one-third of the employees, in addition to the top management, are members of the Party.1053

In addition to its ultimate power over personnel, the Party also sets up other micro-mechanisms such as Party-groups as the constituent bodies within public and private institutions.1054 As the economic enterprises are concerned, the Party-groups have been penetrated not only SOEs, but also private-owned enterprises, including even branches of foreign companies in China.1055 As stipulated in the PRC Companies Act 2014, the CCP may establish Party-groups in all type of companies. Companies must provide necessary conditions to facilitate the establishment and activities of the Party-groups.1056 According to the data released by the department of human resources of the CCP, in the past five years, over 90% of the operating SOEs have established Party-groups; while the number for POEs is around 60%. (Figure 7.2)
For a long time, Party-groups had the roles, including but limited, to ensure and supervise the implementation of policies and guidelines of the Party; to rally and coordinate with non-Party-member cadres, to engage in and decide on major issues of the embedded institution.\textsuperscript{1057} Matters such as restructuring, mergers and mergers between enterprises are therefore subject to the party-groups’ decision. In the Amendment of the Charter of CCP in 2012, two more powerful roles were

\textsuperscript{1057} Article 48, the Charter of CCP 2017
incorporated: one is to provide core leadership to the institution where the Party-groups are installed; the other is to authorized Party-groups to manage cadres in the institutions where they are installed.\textsuperscript{1058}

Recent years have also witnessed another trend which formalises the Party’s micro control penetrating further into the decision making of economic enterprises. An increasing number of companies have amended their constitutional documents to ensure management policy to reflect the Party’s will and influence. (Figure 7.3)\textsuperscript{1059} These amendments embed a deeper management role for the Communist Party in the governance of individual corporations by acknowledging the central role for the internal Party-groups to be consulted on important decisions in “an organised, institutionalised and concrete way”.\textsuperscript{1060}

Figure 7.3, Number of Listed Companies amending Articles of Association to Embed Party Involvement in Corporate Management

Source: Nikkei Asian Review

\textsuperscript{1058} Article 46, the Amendment of the Charter of CCP 2012
\textsuperscript{1060} Jennifer Hughes, ‘China’s Communist Party Writes Itself into Company Law’ (Financial Times, August 14, 2017) <https://www.ft.com/content/a4b28218-80db-11e7-94e2-c5b903247afd> Accessed on 1 October 2017
Take the Industrial and Commercial Bank of China (ICBC), the world’s largest bank by assets, for example. The ICBC’s annual general meeting held on 27 June 2017 approved the amendments to its articles of association. A new article 13 was added as one of the general principles of its corporate governance. The article mandated the establishment of an internal Party-group and expressively endorsed the core leadership of the Party-group within the ICBC.¹⁰⁶¹

In addition, a new Chapter 6 titled *Party Organization*, was strategically inserted before the Chapter 7 on matters related to shareholder rights and meetings. Under the new chapter, Article 52 stipulated that composition of the in-house Party-group; mandated the chair of the board of directors shall be the same person who serve as the head of Party-group. Article 53 listed five main roles of in-house Party-group, including but not limited:¹⁰⁶²

1) To ensure and supervise the implementation of Party’s policies and guidelines within the ICBC;
2) To strengthen its leadership and gate keeping role in the selection, appointment of management personnel within the ICBC;
3) To research and discuss major operational and management issues and major issues concerning employee interests within the ICBC;
4) To lead the ideological and political work within the ICBC;
5) To strengthen the building and function of the grassroots Party organizations and of its contingent of Party members.

The incorporation of these “Party building” provisions to corporate articles of association, is incompliance with the Charter of CCP, the Constitution of the China and the Company Act. It integrates and strengthens the Party’s control within micro corporate governance.¹⁰⁶³ The result is a political economy ecology that institutionalizes all enterprises, whether SOE, POE, or of mixed ownership, to remain embedded into the Party-State governance structure. With this structural arrangement, the Party can govern and control firmly the decision-making process of economic

¹⁰⁶¹ Article 13, the Articles of Association of the ICBC 2017.
enterprises, and can “latch onto the State in a more structured and consolidated manner.”

### 7.1.4 Concluding Remarks

The absolute leadership of the Party shapes the path and the direction of Chinese political and economic development. Owing to the dual constitutional framework, the CCP has obtained a hegemonic control of the State. The Party’s influence is ubiquitous at every level and in every aspect of contemporary Chinese State and society.

To sum up in the Party’s words, the CCP’s leadership is “the defining feature of socialism with Chinese characteristics”. The CCP not only constitutes “the highest force for political leadership”, but also exercises leadership “over all areas of endeavour in every part of the country”. It has made “sweeping efforts to improve the institutions and mechanisms for upholding Party leadership” and it will remain “always a powerful leadership core.”

### 7.2 Corporate Governance Reform to Reinforce State Ownership

State ownership was assumed to be the highest form of public ownership and the goal of socialism. To improve the efficiency and management of the SOEs was one of the key components of “socialist modernization”. The overall strategy is to adopt modern organizational standards in line with Anglo-Saxon style corporation model. This model features characteristics such as: independent legal personality,
limited liability, transferable shares, delegated management under a board structure, and investor ownership.\textsuperscript{1070}

The reform is expected to serve several political economy considerations, including promoting efficiency of SOEs through better management, raising equity capital for SOEs following conversion to the corporate form, expanding State control in key industrial sectors through leverage, and improving the management of State assets through the implementation of the new organizational form.\textsuperscript{1071}

### 7.2.1 Reforming State Ownership

The conventional model of SOEs was referred to as “State-managed enterprises” (SMEs, or in Chinese Guoying Qiye). This model is also referred to as the State-run model, or the State-owned and managed model, which was based on a Soviet management model of command planning.\textsuperscript{1072}

The conventional model was blamed for their inefficiency in managing state assets. Firstly, the unity of ownership and control in the hands of the state under the old system resulted into the imposition of “bureaucratic interference”. Secondly, conflicting objectives occurs with multiple state agencies striving to tender governance over enterprises. Thirdly, the central and local governments, as an ultimate principal, lacked the interest in, and the ability to, effectively police managers and ensure efficient operations.\textsuperscript{1073}

Under this model, the SME is under a tight control by the government. Managing personnel of SMEs were treated with political and economic entitlement equivalent to cadres serving within the Party or Governmental agencies. They were directly appointed and dismissed by government agencies according to the political and economic interests of the Party-State.\textsuperscript{1074}

\textsuperscript{1070} Armour, Hansmann and Kraakman, ‘What is a Corporation?’ in Kraakman and others (eds), \textit{The Anatomy of Corporate Law: A Comparative and Functional Approach} (Oxford University Press 2009)

\textsuperscript{1071} A secondary consideration in passing the Company Law was also the promotion of growth in the non-State sector via the provision of a new organizational form. Donald C. Clarke, ‘Corporate Governance in China: An Overview’ 14 China Economic Review 494


\textsuperscript{1073} Clarke, ‘Corporate Governance in China: An Overview’ 14 China Economic Review 494

\textsuperscript{1074} Cindy A. Schipani and Junhai Liu, ‘Corporate Governance in China: Then and Now’ [2002] Columbia Business Law Review 1
SMEs were not regarded as independent legal persons. Instead, they were referred to as “factories” and functioned as government affiliates. It was the administrative authorities such as the State Council, various ministries, or local governments that managed and supervised these SMEs to produce goods or render services.

Accordingly, SMEs operated under the conventional model are integral part of the general governmental framework of the Party-State. “Unified leadership and hierarchical governance are the government’s principles for running all state industrial enterprises.” As one commentator delineated, the State per se was one “giant vertically-integrated productive firm”; while “ministries were divisions within the firm” and “SMEs were factories”.

7.2.1.1 The First Step

The first stage of reform was initiated in October 1978, when the local government of Sichuan province launched a pilot scheme to grant limited autonomy to six selected enterprises. Instead of submitting all profits to governments, these enterprises were allowed to keep a proportion of their profits when they produced more than the State-set quota. They were free to use that profit to re-invest in research and development, to provide workers and staff with individual bonuses and collective welfare, or to use the profit to maintain a reserve fund.

This has been the case till 1999 with the announcement of the Decision on SOEs Reform, by the 15th CCP Central Committee that declaring that declared “official rankings should not be granted to enterprises and their leaders anymore,” meaning that SOE executives are no longer treated as Government officials. 'CPC Central Committee Major Decision Issued' (People’s Daily Online, September 27, 1999) <http://en.people.cn/199909/27/eng_19990927001005_TopNews.html> Accessed 20 October 2017

Paragraph 1, Article 4 of the 1961 Measures reads, “unified leadership, hierarchical governance, is the principle of the State’s administration on State-run industrial enterprises...” Measures of State-Run Industrial Enterprises Work, which was issued by the CCP Central Committee in 1961 and implemented on a trial basis nationally.

Paragraph 1, Article 4, Measures of State-Run Industrial Enterprises Work, which was issued by the CCP Central Committee in 1961 and implemented on a trial basis nationally.


Following the success of this innovative pilot programme, in July 1979, the State Council released a series of documents, such as the Provisions on Enlarging the Decision-Making Ability for the Operation and Management of SMEs, to encourage other local governments to implement similar projects which increased economic incentives for SMEs. By the end of 1979, about 4,200 enterprises nationwide were selected for this new programme. In 1980, the experiment expanded to include 6,600 large- and medium-sized SOEs, which accounted for 60 per cent of the national budgeted industrial output and 70 per cent of national industrial profits.

In 1981, the central government took one further step forwards, by directly pushing for a so-called economic accountability system which granted more autonomous power to enterprises to allow them to become independent economic units. From then on, the State Council started enacting a series of regulations on SMEs to implement the reform policy.

For example, the State Council enacted Interim Regulations Concerning the Work of Directors of State-owned Factories in 1982. According to this Interim Regulations, the directors were responsible for the day-to-day operation of State-owned Factories, which reduced the direct intervention by the influential party committee. In addition, the State Council in 1983 enacted Interim Regulations on State-owned Industrial Enterprises to, inter alia, affirm the directors as the day-to-day managers, under the supervision of the workers congress and the leadership of the Communist Party.

Despite these efforts to expand the autonomy of the enterprises, SMEs were still vulnerable to governmental control. For example, SMEs were still directly under the leadership of the relevant governmental authorities in carrying out their business operations and production; and the managers were still appointed and dismissed

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1081 Jinglian Wu, “‘Market Socialism’ and Chinese Economic Reform’ (The IEA's Round Table on “Market and Socialism Reconsidered”)
1082 See then Premier Zhao Ziyang’s Report to the 4th Plenary Session of 5th National people’s Congress, in Selected Materials of Important Documents Since the 3rd Plenary Session of 11th Communist Party Central Committee Meeting, the People’s Publishing House, 1987, page 375-77.
1083 Article 5, the Interim Regulations on State-owned Industrial Enterprises.
by the governmental authorities as before. Moreover, the performance of SMEs directors still was not evaluated by the financial performance of the enterprises but by their ability to carry out the plan set down by the Government.

### 7.2.1.2 The Second Stage

The second stage of reform was mainly characterized by the change in SMEs’ profit distribution and the formation of the management responsibility system. The release of the *Decision of Central Committee of Communist Party of China on the Reform of Economic System* in 1984 marked the start of the second stage of the SOEs reform. A “separation between the State ownership and the SOEs management rights” was, for the first time, suggested. Correspondingly, the main goal was to render SOEs responsible for their own financial gains and losses. In its official language, “SOEs should become legal persons that enjoy full management authority and full responsibility for their own profits and losses.”

Accordingly, a contract-based responsibility system was set up as the major operation model of SOEs. The contract-based responsibility system was an operational and management system that established the respective responsibility, rights and interests of the governments and the SOEs in operational contracts according to the principle of separation of ownership and operations. This system allowed enterprises to operate independently and shoulder responsibility for their own profits and losses while complying with socialist public ownership.

In the following years, many regulations were promulgated to enhance market orientation reforms. Among others, the *State-owned Industrial Enterprises Law* promulgated in April 1988 deserves a special attention. It was the first time that the legislative branch, the National People’s Congress, stepped in and provided

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1084 Article 66, *ibid.*  
1086 *The Decision of Central Committee of Communist Party of China on Reform of Economic System* was adopted by the Third Plenary Session of the 12th National People’s Congress on 20 October 1984.  
1087 *The Decision of the Central Committee of the Chinese Communist Party on Several Issues Concerning the Reform of the Economic System*  
1088 *Ibid*  
comprehensive rules regulating the management and operation of SOEs. The Article 2 of the State-owned Industrial Enterprises Law acknowledged that:\textsuperscript{1091}

\textit{The property of the enterprise shall be owned by the whole people,\textsuperscript{1092} and shall be operated and managed by the enterprise with the authorization of the State in line with the principle of the separation of ownership and managerial authority.}

Pursuant to this law, SOEs were allowed, for the first time, to obtain a legal status as an independent legal person with the authorization from the government. The enterprise may, in accordance with the decision of competent government agencies, adopt the contract, leasing or other forms of systems of managerial responsibility.\textsuperscript{1093}

With this period of regulatory development, SOEs incrementally acquired much broader autonomous powers in organizing their production and operation. In terms of personnel management, enterprises were allowed to independently appoint technical and mid-level administrative staff.

This period of reform, however, failed to promote a fundamental change regarding the separation of government administration and enterprise management. Governments still retained the power to recruit or remove those staff at higher levels, such as the factory director; government also held the residual power in important decision making.

\textit{7.2.1.3 The Third Stage}

In October 1992, the 14th National Congress of the CCP decided that China should establish the socialism with Chinese characteristics based on a market economy, i.e., to replace the centrally planned economic system with a market oriented system.\textsuperscript{1094} Accordingly, a process of incorporating of SOEs was put into motion following the \textit{Decision on Many Issues Concerning the Establishment of a Socialist Economic System} published by the 3rd Plenary Session of the 13th Central Committee of CCP.

\textsuperscript{1091} Article 2, the SOEs Law
\textsuperscript{1092} Equivalent to the notation of “State”.
\textsuperscript{1093} Article 2, the SOEs Law
\textsuperscript{1094} The report to the 14th National Congress of the Communist Party of China, given by the Then General Party Secretary Jiang Zeming. See http://news.xinhuanet.com/ziliao/2003-01/20/content_697148.htm
The modern enterprise system, also called the modern business corporation system, was officially declared as the principal goal of the SOEs reform from then on.\textsuperscript{1095}

To implement the CCP’s new policy, three sets of administrative rules were released. The first one was the \textit{Share Enterprise Trial Measures}, which were promulgated by the Commission for the Restructuring of the Economic System (CRES), a department of the State Council.\textsuperscript{1096} Following the Measures, the CRES further released the \textit{Standard Opinion on Companies Limited by Shares}\textsuperscript{1097} and the \textit{Standard Opinion on Limited Liability Companies}.\textsuperscript{1098} This ministerial level of administrative rules laid a foundational framework for the promulgation of a comprehensive companies act, which was adopted by the National People’s Congress in December 1993, and took effect in July 1994. (Companies Act 1994)\textsuperscript{1099}

The enactment of the Companies Act 1994 is regarded as a “milestone” in China’s SOEs reform.\textsuperscript{1100} The Act established the first ever comprehensive corporate law framework for the PRC since 1949.\textsuperscript{1101} As Article 1 states expressly, the policy purpose of the Act is a reflection of the Party’s will to:

1) meet the needs of establishing a modern enterprise system,
2) standardize the organization and activities of companies,
3) protect the legitimate rights and interests of companies, shareholders and creditors
4) maintain the socio-economic order
5) promote the development of the socialist market economy.

According to the Act, traditional SOEs may be restructured and incorporated into three types of companies: limited liability companies, wholly State-owned companies,

\textsuperscript{1095} \textit{The Decision on Many Issues Concerning the Establishment of a Socialist Economic System}, passed at the third plenary session of the 14th Central Committee of the Communist Party on November 1993.

\textsuperscript{1096} Gufenzhi Qiye Shidian Banfa\lbrack\lbrack 股份制企业试点办法\rbrack\rbrack, SCRES Document No. 30 (1992). See http://www.arq.gov.cn/Article/lffg/jlf/gsqy/200701/6981.html.


\textsuperscript{1098} Youxian Zeren Gongsi Guifan Yijian \lbrack\lbrack 有限责任公司规范意见\rbrack\rbrack, SCRES Document No. 31. See http://www.jincao.com/fa/09/law09.45.htm.

\textsuperscript{1099} Schipani and Liu, ‘Corporate Governance in China: Then and Now’ [2002] Columbia Business Law Review 1

\textsuperscript{1100} Wei, ‘The Development of the Securities Market and Regulation in China’ (2005) 27 Loyola of Los Angeles International & Comparative Law Review 479

\textsuperscript{1101} Schipani and Liu, ‘Corporate Governance in China: Then and Now’ [2002] Columbia Business Law Review 1
and joint stock limited companies.\textsuperscript{1102} In addition, a wholly State-owned company is set under this category of limited liability companies for companies invested and established solely by a governmental institution authorized by the State Council.\textsuperscript{1103}

The Act sets out the shareholder supremacy principle and the fundamental corporate governance structure. On the one hand, shareholders’ meetings were defined as the corporation’s supreme power body; one the other hand, the board of directors and the supervisory board operate side by side as the “executive organ” and the “watchdog” respectively.\textsuperscript{1104}

The Act, however, failed to address many legislative gaps such as fiduciary duties, derivative actions and class actions.\textsuperscript{1105} Amending proposals were subsequently made to revise the 1994 Companies Act. The first two revisions occurred in December 1999 and August 2004 respectively, touched a few technical aspects of the Act. The 1999 revision changed two articles, including 1) one new paragraph under Article 67 requiring the installation of a supervisory board in companies fully owned by the State; 2) another paragraph added to Article 292 authorizing the Government to approve a “second board” to support advanced and high-tech companies. The 2004 revision deleted a paragraph from Article 131 to remove the approval requirement by the securities regulatory authorities for issuance of company shares at a premium.

The third revision, published in October 2005 and took effective in January 2006, was almost a rewriting of the Companies Act 1994. Only 24 articles of the 1994 law were left untouched. For this reason, the current Companies Act is customarily referred to as the Companies Act 2006 or simply the “New Companies Act”, rather than a Revision to the Companies Act 1994.\textsuperscript{1106}

\textsuperscript{1102} Article 159, Companies Act 1993 
\textsuperscript{1103} Article 63, Companies Act 1993 
\textsuperscript{1104} E.g., Article 102, 103 on the shareholder meeting; Article 112 on the board of directors; Article 126 on the board of supervisors. 
Further discussion on the corporate governance structure of under the Companies Act is undertaken in above chapter 3. 
\textsuperscript{1106} Companies Act 2006 has brought a wide range of changes and relaxed many of the restrictions upon business incorporation and operation in China, including lowering the capitalization requirement, increasing shareholder and creditor protection, increasing information disclosure and transparency, introducing the fiduciary duties provisions and granting shareholders larger power to launch anti-director lawsuits.
The most recent amendments to the Companies Act took place in December 2013 and became effective as of March 1, 2014. This time of amendment was a direct regulatory response to the reform of the registered capital registration system initiated by the State Council in October 2013. They were set to implement the Party’s policy to facilitate business operations, to reduce governmental intervention and to increase the autonomy of business organisations.\(^{1107}\) The Amendment revises 12 articles to ease the previously stringent capital requirements. For examples, the minimum registered capital requirement was eliminated;\(^{1108}\) the paid-in capital registration system was replaced with a subscription capital registration system;\(^{1109}\) the minimum portion of capital contribution in cash was lifted.\(^{1110}\)

### 7.2.1.4 Continuing control of the Party and the State

Due to the political economy constraints, the vast majority of listed companies in China are, not surprisingly, reorganized State-Owned Enterprises (SOEs). The following figure 7.4 shows that, for the first decade since the adoption of the Companies Act, the ultimate controlling shareholders for more than 80% of the listed firms were the central or local governments, viewed solely from the standpoint of equity ownership.\(^{1111}\)

Figure 7.4: The Different Ownership Types of China’s Listed Companies

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For the details of the 2005 revision regarding to takeover regulations please refer to the chapter 3.
\(^{1107}\) Jingchen Zhao, ‘Promoting a More Efficient Corporate Governance Model in Emerging Markets through Corporate Law’ 15 Washington University Global Studies Law Review 447
\(^{1108}\) Under the previous requirement, the minimum registered capital was set at RMB 30,000) for limited liability companies, RMB 100,000 for one-person limited liability companies, and RMB 5 million for limited liability companies by shares.
\(^{1109}\) The existing paid-in capital system required that the initial capital contribution shall not be less than 20 percent and the registered capital shall be fully paid up within two years (five years in case of an investment company) from the date of establishment.
\(^{1110}\) The existing restriction that the amount of the capital contributions in cash paid by all the shareholders shall not be less than 30 percent of the registered capital of the limited liability company.
Meanwhile, a research conducted by Chen, Fan and Wong found that the politicians and state controlling owners occupy most of board seats.\footnote{Joseph P.H. Fan, T.J. Wong and Tianyu Zhang, ‘Politically connected CEOs, Corporate Governance, and Post-IPO Performance of China’s Newly Partially Privatized Firms’ (2007) 84 Journal of Financial Economics 330} They report that almost 50\% of the directors are appointed by state-controlling owners, and another 30\% are affiliated with various layers of governmental agencies; leaving few seats representing the interest of minority shareholders.\footnote{Liu, ‘Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants’ (2006) 52 CESifo Economic Studies 415}

Chinese corporate governance system is therefore a system under the tight control of the Party – State. The administrative authorities have produced and enforced administrative regulations on the corporate market; meanwhile the controlling shareholders, i.e., the State, tightly control the firms through concentrated ownership and management friendly boards. As Walter and Howie point out, “In China the markets are operated by the State, regulated by the State, legislated by the State, raise funds for the benefit of the State by selling shares in enterprises owned by the State.”\footnote{Carl E. Walter and Fraser J. T. Howie, “To Get Rich is Glorious!” : China’s Stock Markets in the ’80s and ’90s (Palgrave 2001)}

\subsection*{7.2.2 Reinforcing State Ownership with the SASAC}

Since the promulgation of the Companies Act 1994, the Chinese government attempted to promote its State-ownership in the incorporated SOEs.\footnote{Tam, ‘Ethical Issues in the Evolution of Corporate Governance in China’ (2002) 37 Journal of Business Ethics 303} But the State is an abstract form. It needs to play its role as a controlling shareholder through directors or managers as political appointees. Meanwhile, State assets risk being...
misappropriated and siphoned off by these agents whose job is supposed to safeguard State assets.\textsuperscript{1116}

To solve these dilemmas, especially the absence of effective supervision over the state asset management, the 16th National Congress of the CCP held in 2002 proposed a new direction for the State asset management. It prescribed that:\textsuperscript{1117}

\begin{quote}
The State shall promulgate laws and regulations, set up a State asset management system under which the central and local governments represent the State in carrying out their responsibilities as asset contributors and enjoying ownership rights.
\end{quote}

Responding to this party policy, the central government in 2003 set up a designated entity, the State-owned Assets Supervision and Administration Commission (SASAC), as a new ministerial-level authority under the State Council.\textsuperscript{1118} The creation of this designated entity consolidated functions previously scattered over various government agencies.\textsuperscript{1119} It demonstrated the renewed efforts of the government to tackle long-standing problems concerning the maintenance and management of State ownership in the wake of SOEs’ reform.\textsuperscript{1120}

The SASAC is the entity that represents the state as the controlling shareholder of SOEs. Its central mission is to preserve and increase the value of State assets while transforming SOEs into public companies. In this process, the SASAC shall act as a responsible investor in regulating and managing SOEs. Its functions are elaborated as: assuming rights and responsibilities as the owner and safeguard the interests of the

\textsuperscript{1116} In 2001, about 50 listed companies received an inspection, warning, criticism and fine as a result of investigation by the government, most cases involving embezzlement and misappropriation of State assets. See China Corporate Governance Report 2003, Shanghai Stock Exchange (2003).

\textsuperscript{1117} Shanghai Stock Exchange, Executive Summary: The Transformation of Corporate Governance in China. Corporate Governance Report, 2003.


\textsuperscript{1120} The Government initially set up a State Asset Management Agency (SAMA) in 1988, subordinate to the Ministry of Finance (MOF) to exercise the ownership rights of the State and supervise the management of State assets by SOEs. However, this arrangement failed to achieve its goal. China Corporate Governance Report 2003, Shanghai Stock Exchange (2003)
owner; conducting reform and reorganization of SOEs; appointing Boards of Supervisors to monitor SOEs; appointing and dismissing enterprise managers;auditing State assets; and undertaking other tasks assigned by the State Council.1121

Since its establishment, the SASAC has been proactive in carrying out its duties to enhance the management and profitability of State-owned assets. Take the execution of personnel power for example. A recent survey reveals the increasing turnover rate of the management of the central SOEs initiated by the SASAC, concomitant to the shared personnel power arrangement between the CCP and the SASAC.1122 At the large central SOEs, CEOs are appointed and evaluated by the Organization Department of the Party’s Central Committee, while the less senior managers are appointed by the First Personnel Bureau of the SASAC. Appointments and evaluations of top executives at the remaining SASAC-supervised SOEs are made by SASAC only.1123

Another example is the “say on pay”. The SASAC has exercised extensive control over the compensation/remuneration for the managers of SOEs. In 2004, a complex personnel evaluation system was introduced to determining managerial compensations. Accordingly, managers are required to enter into binding annual performance agreements with SASAC specifying evaluation criteria and benchmarks. They are rewarded or punished according to annual performance scores transformed into letter grades from A to E.1124

Moreover, the SASAC has been active in rule making engagements. It has promulgated extensive administrative rules on issues relevant to the State-owned assets.1125 For example, regarding takeovers of State-assets of listed companies, SASAC made rules such as Interim Administrative Measures for the Transfer of State-owned Shares of Listed Companies or Provisions on Acquisitions of Domestic

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1122 Nevertheless, it needs to point out that the appointments of these managers are determined with inputs from the Organization Department of CCP and relevant ministries supervising the industrial sectors. Lin and Milhaupt, ‘We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China’ (2013) 65 Stanford Law Review 697
Enterprises by Foreign Investors. It was also involved in the promulgation of the rules regarding to a takeover transaction made by a foreign investor, for example, Provisions on Acquisitions of Domestic Enterprises by Foreign Investors, which was released by a consortium of other governmental authorities.\textsuperscript{1126}

The special status of the SASAC as both a representative of State investors and a regulator of corporate market was further consolidated by the Law on the State-Owned Assets of Enterprises (SOAE Law), promulgated by the 11th National People’s Congress in 2008. The policy purpose of the SOAE Law was set to consolidate and promote the state-owned sector, to strengthen the protection of state-owned assets, and to safeguard the socialist market economy as the country’s basic economic system.\textsuperscript{1127}

The SOAE Law confirmed expressly the SASAC as the institution performing the function of the investor of State-invested enterprises on behalf of the State.\textsuperscript{1128} The SASAC is mandated to participate into significant decision making process to performing the rights and duties of a shareholder, such as the formulation of the rules, the selection of managers, and other major matters as merger, restructuring, issuance of bonds, provision of large-sum security for others, transfer of major property, large-sum donation, distribution of profits, and so on.\textsuperscript{1129}

In relation to the takeover market, the SASAC’s approval is required once a transaction resulting into the change of the controlling position by the State, or other transactions involving an important State-invested enterprise as prescribed by the State Council.\textsuperscript{1130} Even with respect to transactions where the State has no controlling shareholding position, the SASAC’s approval for State-share transfers might be still mandatory once large national SOEs are involved.\textsuperscript{1131} Consequently, the directors,

\begin{itemize}
  \item \textsuperscript{1126} These include CSRC, MofCOM, SASAC, SAIC, SAT, SAFE. See further on the Chapter one on the China’s regulatory regime over takeover issues.
  \item \textsuperscript{1127} Article 1, The Law on the State-Owned Assets of Enterprises
  \item \textsuperscript{1128} E.g., Article 11, ibid
  \item \textsuperscript{1129} Article 12, 21, 30-33, ibid
  \item \textsuperscript{1130} Article 34, ibid
  \item \textsuperscript{1131} For example, SASAC’s approval is required to transfer shares of a subsidiary of a company under its direct control. Under corporate law principles, only the board of directors of the company directly under its control has authority to approve such a transaction. Lin and Milhaupt, ‘We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China’ (2013) 65 Stanford Law Review 697
\end{itemize}
supervisors and senior managers of a SOEs shall not make decisions on major corporate matters ultra vires or in violation of due procedures.\footnote{Article 26, The Law on the State-Owned Assets of Enterprises}

In brief, the SASAC plays the active role as both a controlling shareholder and a regulatory authority in the governance and management of SOEs. This arrangement features two parallel structures provide for monitoring: one is based on the corporate law structure, with the SASAC as controlling shareholder; the other is based on the Party-State governance structure, which shadows the corporate hierarchy, especially with respect to high-level managerial appointments.\footnote{Lin and Milhaupt, ‘We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China’ (2013) 65 Stanford Law Review 697} In other words, the SASAC arrangement is another organizational manifestation of China’s Party-State political economy ecology.

### 7.2.3 Concluding Remarks

The status quo of China’s corporate governance system features a control-based model, in which the Party – State retains residual control rights in the governance and management of firms of all types. The path leading to the current corporate governance system has been dependent on China’s political economy ecology, on State’s attempt to transit from a planned economy to a market-oriented economy, on government’s objective of raising productivity of its SOEs, maintaining political stability and sustaining economic growth.\footnote{Tam, ‘Ethical Issues in the Evolution of Corporate Governance in China’ (2002) 37 Journal of Business Ethics 303} It is evident that the corporate governance model adopted in China is rooted in China’s unique political economy context. This context constraint determines not only the regulatory framework dominant with administrative rules; but the corporate governance practices dominant with the controlling shareholder – in most cases, the State.\footnote{Liu, ‘Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants’ (2006) 52 CESifo Economic Studies 415}
7.3 Capital Market Development with Tight Government Control

A takeover market is preconditioned on the securities market. The following section will approach the political economy factor underlying the Chinese takeover regulatory pattern by analysing the development of securities market and the forging of a regulatory structure as dominated by the administrative authority, the CSRC.

In China, the securities market was absent for a period of three decades following the CCP’s gaining the control over mainland China in 1949. During this period, the Communist Government adopted the centrally planned economy system, following which securities activities were eliminated altogether along all other forms of free market activities. Nevertheless, things changed when China adopted the so-called Reform and Opening-up policies in 1979. The following development can be divided into three states. Each stage characterized itself with different rules and institutional settings in regulatory structures and supervisory powers.


Following the turmoil caused by successive waves of political campaigns and social unrest from the 1950s, the Communist Party’s new leadership under Xiaoping Deng in late 1970s renounced the nationwide mass political movements; instead, they adopted the reform policy known as “Reform and Opening-up Policy”. Reform refers to the economic liberalization, and the Opening-up means engaging into the outside world. Due to historical reasons such as translation and cultural difference, the term Reform and Opening-up Policy has long been officially used in China. See China vows to press forward with economic reforms China vows to press forward with economic reforms, http://en.ce.cn/National/Politics/200812/18/20081218_17714060.shtml; also Ex-President Hu calls on nation to continue reforms, opening up, http://english.peopledaily.com.cn/90001/90776/90785/6563077.html.

There are also other argument proposing a five-stage development, see for example, Ma, Song and Yang, ‘The Dual Role of the Government: Securities Market Regulation in China 1980-2007’ (2010) 18 Journal of Financial Regulation and Compliance 158; The CSRC also divides the growth of Chinas securities market into three but different periods. The formative period from 1978 to 1992, during which shareholding enterprises, shares, bonds and securities intermediaries emerged in the form of informal markets in many places across China as a result of Deng Xiaoping’s economic reform programme which encouraged a market-oriented approach to resource allocation. The second period from 1993 to 1998 during which more formal structures developed, such as stock exchanges, corporate law and regulatory framework. The third period from 1999 to present, during which more significant additional reforms have been implemented, marked by the 1998 Securities Law which codified the central government’s exclusive authority over the securities market, as well as the 2005-2006 Split Share-holding Structure Reform which converted, legally, all non-tradable shares into tradable ones. China Securities Regulatory Commission(CSRC), China Capital- Markets Development Report (2005); See also Jiangyu Wang, ‘The Political Logic of Securities Regulation in China’ in Guanghua Yu (ed), The Development of the Chinese Legal System: Change and Challenges (Routledge 2011)
7.3.1 Relaunching the Securities Market

The official rebirth of the securities market was marked by the issue of stock in 1984 by *Shanghai Feilo Acoustics Co., Ltd.*, which was the first company issuing stocks to the public since the establishment of the People’s Republic of China in 1949. Shortly after this, the Shanghai Municipal Government issued a local law, the *Interim Administrative Measures Concerning the Issuance of Stock*, which was drafted by the local branch of the People’s Bank of China in Shanghai. This was the first regulation produced by the PRC Government to govern securities transactions. It represented the inception of the Chinese stock market regulatory system.

From then on, regulations on stock transactions started developing exponentially. Both the central government – executed by the state council or its ministry level authorities – and local governments issued numerous laws and rules governing a wide range of aspects related to the securities market. On the level of the central government, for examples: the State Council issued the *Circular Concerning the issue of the Joint Stock System Pilot Programme of the Issuance of Stocks to the Public* in December 1990; three ministry level departments jointly issued the *Circular Concerning the Re-examining and Approving the Pioneer Share-issuing Enterprises which Issued Stocks to the Public* in May 1991. On the level of local governments, for examples: both municipal governments of Shanghai and Shenzhen, the provincial government of Shanxi and the provincial government of Fujian, released various rules to regulate stock transactions.

Riding on the wave of demand for a regulated securities market, on November 26, 1990, the Shanghai Stock Exchange was established, with stocks of eight companies

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1139 Ibid
1140 Such as the People’s Bank of China, the Ministry of Finance, the State Planning Commission, The State Commission for Restructuring the Economic System, and the State Administration for Industry and Commerce.
1141 They are the State Committee for Restructuring the Economic System, the People’s Bank of China, and the State Administration of State Property.
1142 Shanghai City Government released *Administrative Measures for Shanghai Stock Exchange* on November, 1990
1144 The People’s Bank of China Shanxi Provincial Branch released *Administrative Measures for a Corporation’s Issuance of Stocks and Bonds* on 16 December 1985
1145 The Fujian provincial government released Administrative Interim Measures for Corporate Stocks and Bonds in Fujian Province on 21 August 1986
being listed on the first day of trading, shortly afterwards, the Shenzhen Stock Exchange was set up and opened on July 3, 1991 with five listed stocks. The establishment of the two stock exchanges in Shanghai, China’s financial centre, and Shenzhen, the representative “special economic zone”, were milestones of China’s securities market development.

From the very beginning, both stock exchanges were wholly promoted as government agents, instead of being initiated by securities dealers as one witnesses in the US or the UK. The operation of the two stock exchanges was characterized by the tight control of local governments in Shanghai and Shenzhen. Local governments acted as both owners and governors of the stock exchanges. Under this arrangement, the securities market played two fundamental roles: the corporate finance role and the corporate governance role.

Firstly, the securities market was expected to provide leverage to pool in financial resources to support the transformation and growth of SOEs. On the one hand, with the deepening of the corporate reform, the inefficient traditional SOEs required a securities market providing extra capital resources for their further growth. As displayed in Figure 7.5, for the first decade of China’s stock markets, the external fund has been reserved exclusively for SOEs; while the amount of funds raised by SOEs decreased gradually since 2000, it has always been above 70%.

Figure 7.5, Funds Raised by SOEs as Percentages of Total Amount Raised by All Listed Companies.

1146 See the official website of Shanghai Stock Exchange: http://english.sse.com.cn/
1147 See the official website of Shanghai Stock Exchange: http://www.szse.cn/main/en/.
1153 Guoping Li and Hong Zhou, ‘The Systematic Politicization of China’s Stock Markets’ 25 Journal of Contemporary China 422
On the other hand, the securities market was expected to absorb the large amount of bank savings and to maximize the employment of this idle money. From 1978 to 1990, savings in Chinese banks had increased dramatically from RMB 21.6 billion Yuan to RMB 703.420 billion Yuan. The securities market would allow the flow of bank savings to better performing enterprises, and thus exert a better utility. As endorsed expressly by a 1991 government White Paper:

Raising funds through issuing shares to the public could not only absorb the huge amount of unused money in the civil society, but also could convert consumption money into capital for production and construction.

Secondly, to apply the securities market as a leverage to discipline inefficient corporate governance practice was recognized as one of the government’s reform strategies. The securities market was expected to discipline inefficiently managed companies and to improve the corporate governance of those public listed companies. As the price of shares would reflect the managerial efficiency of a

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company,\textsuperscript{1158} poorly managed companies would be exposed to hostile takeovers due to their undervalued share prices.\textsuperscript{1159}

Meanwhile, to float in a stock exchange required potential companies to embrace good corporate governance standards. For example, companies needed to satisfy the minimal capital requirement, demonstrate that it made profits in the past three consecutive years, provide evidence that it was not involved in serious breaches of financial law in the last two years, etc.\textsuperscript{1160} A listed company was also subject to the continuous disclosure requirements and other behaviour rules specifically tailored for them.\textsuperscript{1161}

\textbf{7.3.2 Reinforcing Government Control with the CSRC}

In the first stage of development of a securities market, there were no comprehensive institutional settings underpinning the burgeoning stock market because of the unavailability of either a national regulatory authority or a systematic regulation structure. The regulatory regime was made up of a group of ministries and provincial regulatory bodies that operated rather independently from each other. As such, jurisdictions of regulatory authorities co-existed and often overlapped.\textsuperscript{1162}

\textit{7.3.2.1 Inception of the CSRC's Regulatory Position}

Due to the regulatory hysteresis, the stock market was hit by a flood of securities fraud scandals. Among others, the so called 8-10 Incident\textsuperscript{1163} attracted particularly high attention of the central government. On 10 August 1992, some 700,000 investors packed into Shenzhen Stock Exchange to subscribe to a new share issue. Within four hours, the prescribed five million subscription forms were sold out.

\textsuperscript{1158} There has been also doubt on the efficiency and accuracy of the capital market in pricing shares. See for example, Nicholas H. Dimsdale and Martha Prevezer, \textit{Capital Markets and Corporate Governance} (Clarendon Press 1994).


\textsuperscript{1160} Among others, the Securities Act 1998 through Article 48-62 have articulated detailed requirement regarding the floatation of stocks.

\textsuperscript{1161} See for example, article 63-72, Securities Act 1998.


\textsuperscript{1163} The incident happened on 10 August 1992 hence was named after the date.
The unsuccessful investors suspected that the process of handling subscription forms had been corrupted that most of the forms had illegally gone to relevant officials and their related families and friends through the backdoor. Unsatisfied, they took to the street and caused a violent riot. This became the most serious social disturbance in mainland China since the 1989 Tiananmen Square protests. To resolve the problem, the local government had to order distributing another five million forms the next day.\textsuperscript{1164}

The securities market turmoil alerted the central government. It steeled the government’s determination to reassure a tighter state control over the share market to enhance the efficacy of the regulation of the market.\textsuperscript{1165} Two days after the 8-10 Incident, Zhu Rongji, the then Vice Premier in charge of economic affairs, announced the central government’s plan to set up national regulators for the securities market to transfer the regulatory power from the local government to the national government. Shortly, on 12 October 1992, the State Council set up a dual-entities structure as its effort to establish a national regulatory system for the securities market.

The first entity was the State Council Securities Committee (SCSC), the second entity was the China Securities Regulatory Commission (CSRC). The SCSC was a quasi-ministerial level entity. It was chaired by the prime minister and comprising of representatives from a number of ministries. It was the national authority in charge of the macro-management of the securities market. Meanwhile, the CSRC, whose chairperson is an \textit{ex officio} member of the State Council, was the SCSC’s executive organ. It was charged with direct regulatory responsibility collaborating with local governments.\textsuperscript{1166}

Since their establishment, these two entities have made endeavours to bring the securities market under the control of the central government. For example, upon the recommendation from the SCSC, on 22 April 1993, the State Council released the \textit{Interim Provisions on the Management of the Issuing and Trading of Stocks} (The IPMITS). This was the first nationwide administrative rule to regulate the stock

\textsuperscript{1164} See Carl E. Walter and Fraser J. T. Howie, Privatizing China: The Stock Markets and Their Role in Corporation Reform (John Wiley & Sons (Asia) 2003)

\textsuperscript{1165} Wang, ‘The Political Logic of Securities Regulation in China’ in Yu (ed), The Development of the Chinese Legal System: Change and Challenges (Routledge 2011)

\textsuperscript{1166} Ibid
market, covering stock issuance quality, procedure, underwriting, listing quality and procedure, the content of and approach to information disclosure of listed companies, mergers and acquisitions etc.\textsuperscript{1167}

\textbf{7.3.2.2 Consolidation of the CSRC’s Regulatory Dominance}

Nevertheless, the friction and confusion with respect to regulatory structure remained.\textsuperscript{1168} The SCSC was mainly deemed as a discussion forum without substantial functions by other ministries; while the CSRC lacked the regulatory powers to make rules or to punish illegal market conducts.\textsuperscript{1169} More significantly, both stock exchanges were still controlled by the local municipal governments respectively; and the security apparatus still under the management of the People’s Bank of China.\textsuperscript{1170} As Green observes:\textsuperscript{1171}

\begin{quote}
Local leaders’ equity developmentalism during 1993-1997 was especially frustrating for the central leadership because of their new ambition to enlist the share market in support of SOEs reform on a much larger scale than before...

While the secondary market was so volatile, manipulation so extensive, the risks of a market crash so high, the CSRC’s regulatory abilities so limited and local administrative influence so far-reaching, their programme could not be effectively rolled out.
\end{quote}

As a result, the central government decided to strengthen CSRC’s status as the sole central regulatory authority with full jurisdiction over the securities industry.\textsuperscript{1172} The central government streamlined the regulatory regime at the central level by granting...

\begin{itemize}
\item \textsuperscript{1167} It contained the basic rules to regulate the stock issuance and exchange, and although some of these rules were subsequently made redundant by the implementation of rules on Company Law and Securities Law, at the time of its introduction it was undoubtedly important. See also chapter 1 on the takeover regulatory regime.
\item \textsuperscript{1168} Chen, ‘Legal Development in China’s Securities Market during Three Decades of Reform and Opening-up’ Asian Law Institute Working Paper Series, WPS005, 2009
\item \textsuperscript{1169} Wang, ‘The Political Logic of Securities Regulation in China’ in Yu (ed), The Development of the Chinese Legal System: Change and Challenges (Routledge 2011)
\item \textsuperscript{1172} The People’s Bank, the local Government s, and even the stock exchanges were not happy to have the CSRC as the sole regulator replacing their authority position. Walter and Howie, Privatizing China: The Stock Markets and Their Role in Corporation Reform (John Wiley & Sons (Asia) 2003) , at 9-10
\end{itemize}
the CSRC exclusive regulatory power over the securities market. On the one hand, the People’s Bank of China was excluded from the securities market regulation; on the other hand, the SCSC was dismissed and all its regulatory functions were transferred to the CSRC in April 1998. Consequently, the CSRC was upgraded as an independent ministry rank unit directly under the leadership of the State Council.

Meanwhile, the State Council decided that local authorities such as the Shanghai stock exchanges and Shenzhen stock exchange should be placed under the direct control of the CSRC. This was achieved by the release of the _Measures for the Administration of Stock Exchanges_ in 1997 by the State Council. The 1997 _Measures_ excluded the local governments from exerting jurisdiction over both stock exchanges by granting the CSRC the authority, *inter alia*, over the appointment of the exchanges’ senior management.\footnote{1173} From then on, the two stock exchanges became as affiliates of the CSRC. This result is reflected in the governance structure of the stock exchanges. (Figure 7.6)\footnote{1174}

Figure 7.6 Governance Structure of China’s Stock Exchanges

\footnote{1173} Also the power to request the exchange to punish their members and listed companies; to suspend trading; and to sanction the exchanges for failure to enforce any regulation. Green, ‘Equity Politics and Market Institutions: The Development of Stock Market Policy and Regulation in China, 1984-2003’ (2004) Available at SSRN: http://ssrn.com/abstract=509342 or http://dxdoi.org/102139/ssrn509342

The status and powers of the CSRC was consolidated in 1998 with the promulgation of the Securities Act 1998. The Securities Act from a statutory perspective clarified and affirmed the CSRC as the sole regulatory authority over the national securities market in China.\textsuperscript{1175} The Act sets out the roles of CSRC in Chapter X, Securities Regulatory Body. Among others, article 179 prescribes the detailed powers regarding the supervision and administration of the securities market by the CSRC.\textsuperscript{1176} From

\textsuperscript{1175} Article 7 & 166, Securities Act.
\textsuperscript{1176} Article 179, Securities Law:
The securities regulatory authority under the State Council shall perform the following functions and duties regarding the supervision and administration of the securities market:
1) Formulating the relevant rules and regulations on the supervision and administration of the securities market and exercising the power of examination or verification according to law;
2) Carrying out the supervision and administration of the issuance, listing, trading, registration, custody and settlement of securities according to law;
3) Carrying out the supervision and administration of the securities activities of a securities issuer, listed company, stock exchange, securities company, securities registration and clearing institution, securities investment fund management company or securities trading service institution according to law;
4) Formulating the standards for securities practice qualification and code of conduct and carrying out supervision and implementation according to law;
5) Carrying out the supervision and examination of information disclosure regarding the issuance, listing and trading of securities;
6) Offering guidance for and carrying out supervision of the activities of the securities industrial association according to law;
then on, a centralized regulatory regime over China’s securities market was finalized under the CSRC.

In order to enhance the efficacy of the regulatory regime, the Securities Act delegates the legislation power to the CSRC to formulate rules, regulations, guidance, or standard relevant for functions of the securities market. In relation to the takeover transaction in the securities market, the CSRC has made far-reaching regulatory efforts. It issued the *Administrative Measures for the Takeover of Listed Companies* (Takeover Measures) in 2002, subsequently amended it in 2006, 2008, 2012, and 2014. The Takeover Measures, having compiled and replaced various scattered regulations published before, has significantly expanded the takeover rules under Chapter 4 of the Securities Act, and has thus made itself comprehensive in coverage of various takeover transactions.

The dominant status of CSRC was further entrenched with the amendments to the Securities Act. After twice revision, the Securities Act has granted a much broader set of regulatory powers to the CSRC. For example, the revised Article 179 and Article 180 confer on CSRC a range of investigation and information-gathering powers to carry out enforcement of the applicable rules, to investigate and impose sanction on violation of the law and regulations. Previously, the CSRC needed to apply to the

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7) Investigating into and punishing any violation of any law or administrative regulation on the supervision and administration of the securities market according to law; and
8) Performing any other functions and duties as prescribed by any law or administrative regulation. The securities regulatory authority under the State council may establish a cooperative mechanism of supervision and administration in collaboration with the securities regulatory bodies of any other country or region and apply a trans-border supervision and administration.

1177 Article 101, Securities Act
1178 See further in chapter 3
1180 Also previous regulations set by IPMITS, Companies Act.
1182 Article 179, Securities Act:
The securities regulatory authority under the State Council shall perform the following functions and duties regarding the supervision and administration of the securities market:
1) Formulating the relevant rules and regulations on the supervision and administration of the securities market and exercising the power of examination or verification according to law;
2) Carrying out the supervision and administration of the issuance, listing, trading, registration, custody and settlement of securities according to law;
3) Carrying out the supervision and administration of the securities activities of a securities issuer, listed company, stock exchange, securities company, securities registration and clearing institution, securities investment fund management company or securities trading service institution according to law;
courts for asset detention orders, which, due to various reasons such as local protectionism, had been often refused by the court. But after the revisions to the Securities Act, now the CSRC alone can decide whether to detain corporate assets which are in jeopardy of dissipation or improper removal.

The CSRC’s regulatory power has penetrated into China’s capital market deeply. For example, it has the power of final approval of the listing and trading rules of Chinese stock exchanges. It may even order the delisting of non-profitable or poorly performing listed companies. In comparison, although the US’s counterpart, the SEC, has also broad supervisory and investigative powers, the latter has a comparatively limited role in regulating company listing and internal stock exchange operation.

This different breadth of regulatory power of the CSRC and the SEC could be attributed to their dependency on their embedded political economy ecologies. The securities market and securities regulation in China was introduced as instruments to promote traditional SOEs performance, which formed the “essential component” of the political economic reform since 1979. Therefore, the creation and function of the CSRC is tightly linked to China’s enterprise reform. In the US, the states had pre-empted the regulatory power over corporations; a robust securities legal regime was

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4) Formulating the standards for securities practice qualification and code of conduct and carrying out supervision and implementation according to law;
5) Carrying out the supervision and examination of information disclosure regarding the issuance, listing and trading of securities;
6) Offering guidance for and carrying out supervision of the activities of the securities industrial association according to law;
7) Investigating into and punishing any violation of any law or administrative regulation on the supervision and administration of the securities market according to law; and
8) Performing any other functions and duties as prescribed by any law or administrative regulation. The securities regulatory authority under the State council may establish a cooperative mechanism of supervision and administration in collaboration with the securities regulatory bodies of any other country or region and apply a trans-border supervision and administration.

Article 180, Securities Act
Article 118, ibid
deemed as an effective strategy of federal control over securities and corporate systems.\textsuperscript{1189}

### 7.3.3 Reforming the Split Share Structure

The Chinese stock market was primarily to serve as a conduit to enable companies, especially incorporated SOEs, to raise capital from external investors. In developing the stock market, Chinese leaders have to assure that the incorporation and the floatation of SOEs would not undermine the State control of the “means of production by the people”.\textsuperscript{1190} The State control in the securities market is manifested by the tradable v. non-tradable split share structure in China’s securities market.\textsuperscript{1191}

Since the launch of China’s stock market, there are four classes of shares in the market, including State Shares, Legal Person Shares, Individual shares, and Foreign Capital Shares. The State Shares and the Legal Person Shares, for a long time, are non-tradable shares. They were only allowed to be transferred through private agreements upon the approval of governments, instead of free floatation and exchange in the open market.\textsuperscript{1192}

Through the split share structure, the State retained the control of listed companies via directly holding State Shares,\textsuperscript{1193} or indirectly holding Legal Person shares.\textsuperscript{1194} Thus,

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\textsuperscript{1190} The maintenance of “correct” ideology is indeed necessary to ensure survival of the political leaders. Marxist-Leninist ideology, as expressed in China’s 1982 Constitution, is based on “socialist public ownership of the means of production”, namely, “ownership by the whole people and collective ownership by the working people”. Article 6, Constitution 1982.

\textsuperscript{1191} In a developed capitalist market, the idea is that “all shares are equal.” Nevertheless, there are also different types of stocks which are, most commonly, common and preferred shares. The distinction between these two classes arises as a result of the investors’ dividend expectations, voting rights and priority in liquidation. Apart from these differences, shareholders of each class of shares are entitled to equal rights and equal benefits, irrespective of their origin and citizenship. See William I Friedman, ‘One Country, Two Systems: The Inherent Conflict Between China’s Communist Politics and Capitalist Securities Market’ (2002) 27 Brooklyn Journal of International Law 477.

\textsuperscript{1192} Fuxiu Jiang and Kenneth A. Kim, ‘Corporate Governance in China: A Modern Perspective’ 32 Journal of Corporate Finance 190

\textsuperscript{1193} State Shares are those issued and held by the State. If an SOE is the only promoter, it transfers all its rights and obligations to the JSC and then it terminates once the JSC is established. The shares subscribed by an SOE as promoter must be held by a Government organisation or by a controlling company authorised by the Government. Liufang Fang, ‘China's Corporatization Experiment’ (1995) 5 Duke Journal of Comparative & International Law 149.

\textsuperscript{1194} Legal Person shares may be owned by the State where several SOEs promote the company and continue to exist after incorporatisation of the company, and where the SOEs are not promoters but instead subscribe for shares in the company. They may also be owned by a legal entity other than the State, such as another company. Based on the source of the capital, Legal Person shares can be subdivided into State-owned Legal Person shares, Collective Enterprise Legal Person shares, Private Enterprise Legal Person shares, Foreign Enterprise Legal Person shares and Institutional Legal Person shares. \textit{Ibid.}
while the State gave up its exclusive ownership of incorporated SOEs; it did not risk the controlling position in the stock market.\textsuperscript{1195} As one commentator has insightfully suggested, “as long as the State retains a controlling interest in the enterprise, no assets of the State have been sold; rather private capital has been brought under State control.”\textsuperscript{1196}

The split share structure renders the State to maintain control over China’s enterprises. But it had resulted in conspicuous market-dragging problems that must be tackled for the sustainable growth of the market.\textsuperscript{1197} For example, it engendered severe incentive conflict between the holders of tradable shares and the holders of non-tradable shares. The former was unable to control the company due to lack of controlling shareholding position, thus the main form of returns from their investment would be the increase in share prices. Meanwhile, the latter as the controlling shareholders had limited incentives to pursue share price maximization because they did not directly benefit from stock price appreciations. The diversion of the interests and powers of different shareholders became a buffer, shielding managers from effective shareholder pressure to improve the company’s performance and profitability.\textsuperscript{1198}

The State’s control over China’s enterprises with the split share structure also comes at the expense of liquidity in the stock market.\textsuperscript{1199} Markets are liquid when investors can buy or sell shares without too many constraints.\textsuperscript{1200} Fair market liquidity is one essential feature of an efficient market. It is important not only for initial public offerings and/or subsequent offerings, but also for monitoring the corporate operation and the management performance.\textsuperscript{1201} The limited transferability of both State Shares

\textsuperscript{1196} Gu, Understanding Chinese Company Law (Hong Kong University Press 2006)
and Legal Person shares constrained the fair liquidity of the stock market, hence the functions of the market.\textsuperscript{1202}

It became apparent that the split share structure had become a culprit causing the stagnant stock market in China.\textsuperscript{1203} To reform the system became “a must for boosting investor confidence and market performance finally the development of the securities market.”\textsuperscript{1204} Eventually, the CSRC initiated a pilot scheme in April 2005. This pilot scheme started with converting non-tradable shares to tradable shares of 4 listed firms.\textsuperscript{1205} A full transformation occurred quickly after the pilot scheme. In June 2005, 42 listed firms were involved in the programme; in August 2005, the programme was expanded to all listed firms. By the end of 2007, about 1298 listed companies had completed the process of floating the non-tradable shares, which accounted for 98% of the total listed companies.\textsuperscript{1206}

The reform on the split share structure has been praised as “the most important and revolutionary institutional reform” of the Chinese securities market since the stock market were inaugurated.\textsuperscript{1207} The accomplishment of the share reform has profound impacts. The following part discusses three aspects of impacts relevant to takeover market and its regulation.

Firstly, the reform enhanced the transferability of the shares. Figure 7.7 shows the percentage of shares that are non-tradable and tradable, before and after the reform. In 2003, the mean (median) percentage of non-tradable shares by firm is 60.22% (62.6%); while the tradable shares accounts only 39.8% (37.9%). In 2007, the mean (median) percentage of shares that are tradable, by firm, is 53.8% (53.9%). By 2012, majority of shares is tradable in more than half of the firms. Specifically, the mean

\textsuperscript{1204} Ibid.
\textsuperscript{1205} The non-tradable share reforms required holders of non-tradable shares to pay compensation to tradable shareholders in return for the right to sell their shares on stock exchanges. This compensation could be in form of cash or the gratuitous transfer of stock (non-tradable shares), among others.
\textsuperscript{1207} “China determined to complete stock market reform in short time”, \textit{China Daily}, June 28, 2005.
(median) percentage of shares that are tradable, by firm, is 76.5% (95.4%). That is, for the median firm, almost all of its shares are tradable.¹²⁰⁸

Figure 7.7, Percent of Non-Tradable Shares and Tradable Shares.

<table>
<thead>
<tr>
<th>Year</th>
<th># of obs</th>
<th>% of Nontradable (restricted) shares</th>
<th>% of Tradable shares</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>mean</td>
<td>median</td>
</tr>
<tr>
<td>2003</td>
<td>1197</td>
<td>60.22</td>
<td>62.06</td>
</tr>
<tr>
<td>2004</td>
<td>1207</td>
<td>66.37</td>
<td>62.25</td>
</tr>
<tr>
<td>2005</td>
<td>1311</td>
<td>58.34</td>
<td>60.30</td>
</tr>
<tr>
<td>2006</td>
<td>1375</td>
<td>51.53</td>
<td>52.31</td>
</tr>
<tr>
<td>2007</td>
<td>1490</td>
<td>46.18</td>
<td>46.07</td>
</tr>
<tr>
<td>2008</td>
<td>1507</td>
<td>40.85</td>
<td>41.10</td>
</tr>
<tr>
<td>2009</td>
<td>1628</td>
<td>28.51</td>
<td>24.73</td>
</tr>
<tr>
<td>2010</td>
<td>1855</td>
<td>27.98</td>
<td>16.48</td>
</tr>
<tr>
<td>2011</td>
<td>1976</td>
<td>25.38</td>
<td>10.01</td>
</tr>
<tr>
<td>2012</td>
<td>2062</td>
<td>23.50</td>
<td>4.53</td>
</tr>
</tbody>
</table>

Source: Jiang & Kim, *Corporate Governance in China: A Modern Perspective*

Secondly, the reform induced China’s securities market toward a dispersed ownership structure. The gradual conversion of non-tradable shares made it possible to trade shares owned by the State and Legal Persons in the open market. Through a gratuitous conveyance, the non-tradable shares previously owned by the State were transferred to other institutional or individual holders. The percentage of shares held, directly or indirectly, by the State has been reduced. (Figure 7.8)¹²⁰⁹

Figure 7.8, Market Capitalization of Listed Firms 1991 – 2016 (Trillions of RMB)

¹²⁰⁸ Jiang and Kim, ‘Corporate Governance in China: A Modern Perspective’ 32 Journal of Corporate Finance 190
Note: The time series of market capitalizations is split at year 2006 to accommodate the significant increase of the capital due to the reform of split share structure.

Source: Carpenter & Whitelaw, The Development of China's Stock Market and Stakes for the Global Economy

Thirdly, the reform created conditions more conducive to the market for corporate control. The split share structure caused a separate set of supply and demand forces which led to different prices and earnings ratios for the same shares. After the integration of shares, it became a tendency for the share price to reflect the enterprise value and thus the performance of corporate management. Hostile takeovers became a more likely possibility in the capital market to impose external pressure on the management. In this regard, China’s policy makers are working toward establishing an environment conducive to the takeover market.

7.3.4 Concluding Remarks

In summary, the primary objective of developing the Chinese stock market was to find an alternative financing venue for SOEs and to improve corporate governance and performance of SOEs. The policy objective rendered the securities market and its embedded takeover market dependent on the contextual political economy ecology. Administrative governance approach was adopted to control the direction and regulation of the market development. The controlled based approach dictates that securities market regulation in China follows a path of compulsory institutional change, or government-oriented institutional evolution.

Consequently, the market was heavily regulated firstly by various government departments and local authorities at the burgeoning stage, and then the CSRC as the

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predominant central regulator of the national market. In this process, the State is playing two roles at the same time: the shareholder and the regulator. This political economy situation renders regulatory systems asymmetrically in favour of the State shareholders, SOEs or the companies with close ties to the government.

7.4 Interest Group Influences

In the shape of takeover regulations, interest groups involved usually include shareholders, managers, labors and third-party advisors (lawyers, financial consultants, etc.). These interest groups, however, differ in their ability to mobilize and exert pressure in adoption of rules that serve the best interest to them. The more resourceful a group is, the more influence that group would tend to have in the law-making process.\textsuperscript{1212} The making of the takeover regulations, therefore, depends on how relevant interest groups would exert their utmost influence.\textsuperscript{1213} As mentioned earlier, the institutional investors in UK and the professional managers in US have played dominant role in the form of distinct regulatory patterns over takeover markets in each country.\textsuperscript{1214}

In China, nearly every political force has been integrated into the Party-State governance system.\textsuperscript{1215} The Party has been pervasively involved across all spheres of political, economic, and social activity. Meanwhile, the government is simultaneously the player and the regulator of the market. The economy and market are controlled by different administrative departments over the course of its development, and eventually integrated into China’s market socialism through the creation of a centralized administrative regulatory framework.

Public choice theory calls attention to the self-interested behaviour of regulators who seek to maximize their interest of control and politicians who give priority to securing

\textsuperscript{1213} Xi, ‘In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China’ (2006) 22 Connecticut Journal of International Law 1
\textsuperscript{1215} Zhu, ‘Political Parties in China's Judiciary’ (2007) 17 Duke Journal of Comparative & International Law 533
political support in order to increase their chances for staying in power.\textsuperscript{1216} Regulatory authorities are themselves interest groups seeking to forward their own interests and to enhance their dominant power in the market.\textsuperscript{1217} This self-reinforcing phenomenon is more vivid in authoritarian nations such as China.

As we discussed in Chapter 3 on the features of current regulatory regime in China, the CSRC has presented itself as the predominant regulatory authority and has continued expanding its regulatory territory. The institutional capture results in the stock exchanges to lose their autonomy power and avoid the existence of a self-regulatory power such as the UK Takeover Panel. Hence the current development of its regulatory power and status suggests that the function of the CSRC as the central administrative authority over the securities market is firmly established.\textsuperscript{1218}

The Party \textit{per se} constitutes the ultimate interest group.\textsuperscript{1219} In this sense, the tight control under China’s takeover rules over the power of directors in face of a takeover bid reflects a broader concern relating to the ideology of the persistent State shareholders dominant position, here a market controlled by the State. The narrow scope of the managerial power may also serve to prevent the aggregated uncertainty of a takeover offer triggered by anti-takeover measures; hence to prevent the emergence of any organized forces outside the political establishment of the Party-State.

Nevertheless, China is in the process of going through a transition from a planned economy to a market-oriented system. The on-going transition has incrementally changed, more or less, the distribution of power between the Party-State, economic enterprises and other private market players.\textsuperscript{1220} Private market actors have also become increasingly conscious of the organizational straightjacket imposed by the law and regulation. There appear signs that they have started to engage proactively in

\textsuperscript{1216} Victor Nee, Sonja Opper and Sonia Wong, ‘Developmental State and Corporate Governance in China’ (2007) 3 Management and Organization Review 19

\textsuperscript{1217} Roe and Vatiero, ‘Corporate Governance and its Political Economy’ in Gordon and Ringe (eds), \textit{The Oxford Handbook of Corporate Law and Governance} (Oxford University Press 2017) <Available at SSRN: http://ssrn.com/abstract=2588760 or http://dx.doi.org/10.2139/ssrn.2588760>

\textsuperscript{1218} Wei, ‘The Development of the Securities Market and Regulation in China’ (2005) 27 Loyola of Los Angeles International & Comparative Law Review 479

\textsuperscript{1219} Lin and Milhaupt, ‘We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China’ (2013) 65 Stanford Law Review 697

\textsuperscript{1220} Tony Saich, \textit{Governance and Politics of China} (Palgrave Macmillan 2011)
the Chinese policy process. For example, many interest groups have been reported to lobby the NPC to amend corporate rules they disfavoured or to adopt rules that they favoured in recent amendments to Companies Act.

In addition, under the management of the SASAC, large economic enterprises, especially those national champion SOEs, are now forceful players in the Chinese political economy. In the shape of the US takeover regime, large corporations in the US have exerted tremendous influence on the design and promulgation of Takeover Statutes by local State governments. It is possible that China’s law and practice will adapt in ways that reflecting the best interests of large economic enterprises in China as well.

The question arises as to whether, or more critically to what extent, these economic organization or private market groups in fact will exert their power in the political process to influence the future regulatory trajectory of takeover market. Because this analysis cannot be more than a rough estimation without applying quantitative methodologies, including conducting interviews, questionnaires etc.; the author here will not put together the limited available evidence with a strong element of speculative reasoning. The assessment of the influence of these interest groups in the making of takeover rules will have to be left for further empirical research.

Conclusion

The chapter illustrates how China’s political economy context shapes its takeover regulations by determining the embedded corporate governance system and securities market. The author examines how the administrative control based regulatory model emerged and why the shareholder oriented board neutrality rule prevails as one of the substantial principles guiding takeover regulations in China.

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1221 Merle Goldman, From Comrade to Citizen: The Struggle for Political Rights in China (Harvard University Press 2005)
1223 Further discussion is in Chapter 6
The hegemonic position of the Communist Party in the Party-State system has projected the fundamental feature for the China’s political economy ecology. The CCP’s status as the ruling party of the State is not achieved through elections as in a democratic country. It must apply other means to hold on to the power.\textsuperscript{1224} This political objective determines the State’s policy orientation toward the reform of corporate governance system and the development of the securities market: the regime has to ensure that it controls sufficient financial and other resources.\textsuperscript{1225} The existence of dominant SOEs in the market is not only one of the major characteristics of the Chinese economic system, but also an “indispensable economic foundation for the rule of the Chinese Communist Party”.\textsuperscript{1226}

The efficiency-oriented enterprise reforms paved the way for developing corporate law and regulation with the purpose of enhancing the overall control and performance of SOEs by the government. The development of the Chinese capital market accelerated the enterprise reform and the inauguration of a market for corporate control with the similar underlying political economic rationale. Both corporate governance reform and securities market development provide the vivid example and unique evidence of how a government lead and controlled regulatory pattern is likely to evolve if the government is both the regulator and the market player.\textsuperscript{1227}

To sum up, identifying self-reinforcing processes of political economy underpinning the corporate reform and the securities market evolution helps us to understand where China’s current regulatory pattern over the takeover market was derived from and why the regulatory practices will be persistent. As echoed by the first chairman of CSRC, Mr. Hongru Liu, the biggest lesson he had learnt from the development of China’s securities market was that the regulatory work in China is always about “30 per cent business; 70 per cent politics.” (\textit{sanfen yewu, qifen zhengzhi})\textsuperscript{1228}

\textsuperscript{1224}The most important of which is to deliver sustained improvements in consumption and living standards to the Chinese people through economic growth. Wang, ‘The Political Logic of Securities Regulation in China’ in Yu (ed), \textit{The Development of the Chinese Legal System: Change and Challenges} (Routledge 2011)

\textsuperscript{1225}Ibid

\textsuperscript{1226}Ibid


\textsuperscript{1228}Wang, ‘The Political Logic of Securities Regulation in China’ in Yu (ed), \textit{The Development of the Chinese Legal System: Change and Challenges} (Routledge 2011)
Chapter 8: Conclusion

This thesis develops an enhanced theory of path dependency and applied the theory to interpret multi-equilibria of takeover regulations. The regulatory heterogeneity is observed across China, Britain and America regarding regulation structures, regulatory institutions and substantive rules. It is shown that the path dependency theory, when combined with legal origins theory and political economy theory, can explain the puzzling fact that takeover markets have been subjected to various regulatory patterns in above three jurisdictions.

In this concluding Chapter, I will first address the unresolved issues and indicate pathways for future research. The second section returns to the core questions posed in the introductory chapter with a summary of respective answers revealed by discussion throughout the subsequent chapters.

8.1 Unresolved Issues and Future Research

The theoretical framework developed in this thesis makes strong reference to two closely related theories, legal origins and political economy, as developed in law and development field to grapple with the implications of path dependency in takeover regulations. This research contributes to the debate on the path dependency theory by applying the theory to explaining different legal developments as the explanatory core. The theoretical framework can increase the applicability of path dependency as an explanatory concept in the field of comparative corporate governance and lay the ground for the law and development analysis in more depth in future.

Looking ahead, this thesis represents only a first step towards a deeper understanding of takeover regulation in emerging markets like China. There is further research to be undertaken. The following discussion addresses two unresolved issues which will form the basis for future research.

8.1.1 The comparative examination of regulatory patterns

Upon the arrival of rampant takeover activities, various jurisdictions across the world have developed their respective institutional responses to regulate the takeover market. The thesis has taken the UK and the US as two reference points to compare with China. This small number of comparative samples suffices to serve the purpose of affirming the existence of multiple regulatory equilibria over takeover markets. The analytical framework will provide a tool to contemplate related issues in other economies, especially in emerging markets and transitional economies. A thorough comparative study on other markets, including, but not limited to, BRICS countries, will present richer information on the multiplicity of the regulatory equilibria; and contribute further to the debate on the convergence or divergence of comparative corporate governance.

8.1.2 The empirical assessment of regulatory efficiency

The main focus of the research by law and finance scholars is on the interaction between the historical legal origins, the systems/quality of law, and the economic prosperity especially the financial market growth of a country. They have, refutably, documented that the historical origin of a country’s legal system is highly correlated with the “quality” of its current legal system hence its economic prosperity. Part II of the thesis examines the influence of the original condition for takeover regimes in the UK, the US and China. The normative assessment of the efficiency of the takeover regimes in these countries, and the correlation or causation linked to the economic outcomes, will have to be established in further research with more sufficient empirical data.

8.2 Questions and Answers

The main theme of this thesis is that there is a significant path dependency phenomenon in the evolution of the regulatory regime governing takeover markets. In essence, a path dependency phenomenon presents a dynamic feature of the self-reinforcing, or lock-in effects contingent on initial conditions of a given set of arrangements. In the first chapter I poses four main research questions. What are the current main regulatory patterns across the world in regulating the hostile takeovers?
What are the characteristics of the current Chinese legal regime over hostile takeovers? What forces have driven the current Chinese legal regime in the area of hostile takeover regulation? Should we expect the persistence of the divergences or convergences of the takeover legal regime across different jurisdictions in the world?

8.2.1 Answers to the first two research questions

Part I establishes that there exists more than single regulatory equilibrium regarding to the takeover market across the world. China has developed a unique regulatory pattern which differentiates itself from regulation in the UK and the US. On the one hand, China has established a controlled-based regulatory mode within which a centralized administrative organ has been predominant in both the provision and the enforcement of the regulation of takeover market. This controlled-based mode contrasts itself with the traditional dominance of the private City Code enforced by the independent Takeover Panel in UK, and the dominance of case law developed by the Delaware State Court supplemented by statutory acts in the US.

On the other hand, substantive rules with pro-shareholder orientation have features in Chinese takeover law. For example, the principle of “board neutrality” has been adopted as one of the basic rules in China’s Takeover Measures. Accordingly, when faced with a solicited offer, the board of a target company is only permitted to adopt defensive mechanisms which require shareholders’ approval; or to continue to carry on activities in the ordinary course of its business. This principle resembles the non-frustration rule as defined under the UK Takeover Code; whilst the non-equivalent principle is provided under the takeover regime in the US.

An analysis on the regulatory pattern of the takeover market in China, as compared to the UK and the US, reveals strong diverse elements of change and continuity. However, the status quo analysis alone does not allow us to understand why one country’s regulatory system has reached a particular equilibrium nor what trajectory that system is likely to take in the future. How then should we understand the rather complex process of change and continuity underway in national systems of takeover regulation? The answer lies in the analysis of the historical, political and economic forces that shape the evolutionary path of a legal system.
8.2.2 Answers to the third research question

The established multiplicity of takeover regulatory equilibria poses the task of identifying the underlying forces shaping these equilibria. These forces can be attributed to the underpinning explanatory properties of the path dependency theory: influence of initial conditions and impact of a self-reinforcing mechanism. These two properties could be linked to two main streams of law and development literature: the law and finance literature on one hand, the political economy literature on the other hand. The explanatory power of the path dependency theoretical framework could be well appreciated with the interpretation of the contingent original conditions and political economy constraints of individual jurisdiction. The interplay of the legal origins and the political economy has contributed to the establishment of a regulatory pattern with Chinese characteristics, which differentiate itself from both the UK pattern and the US pattern.

Part II conducts the analysis of path dependency on initial conditions from the legal origins perspective. It has been found that the contemporary Chinese legal system in general is a hybrid product. It has been influenced heavily by Western legal norms while encapsulating features inherited from China’s feudal past, communist ideology and practice. These streams of legal origins continue having institutional consequences penetrating into the takeover regulations to this day in China.

Part III focuses on the analysis of the self-reinforcing path dependency from the political economy perspective. It has been found that the Party – State’s policy to maintain political and economic control over Chinese society has a remarkable effect on the regulation of Chinese takeover market. The political economy constraints mandate the government to function as both the active regulator and the dominant participant of the market for corporate control. The analysis presents an example of how China’s government lead, and controlled regulatory equilibrium, has come to existence.

8.2.3 Answers to the last research question

Which direction will the corporate governance and takeover regime reforms lead to in future? The overall path dependent theory suggests that existing regulatory patterns
are deeply embedded in given historical, political and economic institutional contour, and tends to be extremely persistent to withstand regulatory paradigm shifts. Therefore, important differences will persist in the future.

This, by no means, claims that path dependency phenomenon is a story of inevitability in which the past could neatly predict the future; or “the social landscape can be permanently frozen”. That is neither the assertion, nor the research findings of this thesis. Change to the legal system does occur. But it is bounded change. Previously viable options are foreclosed in the aftermath of a sustained period of positive feedback, and cumulative commitments on the existing path makes change difficult. As North summarizes, “Path dependence is a way to narrow conceptually the choice set and link decision making through time.”

If we take China as an example, ensuing legal reform will further enhance the government’s control over the Chinese market for corporate control. Increasing regulatory principles and substantial rules are used to ensure the Party-State governance structure. In the future, management of public companies might take on somewhat more power within the firm level governance, but they will hardly alter the fundamental corporate governance system.

To repeat the mantra: the thesis has affirmed the path dependent phenomenon of takeover regulations in three jurisdictions. It shows how a regulatory pattern that a jurisdiction has is likely to depend on historical influences and political constraints. Hence, the convergence of systems of corporate governance, or the “End of the History for Corporate Law” era as proclaimed by legal convergence proponents, seems at best to be a distant possibility and more likely a remote one.

Fukuyama’s “End of History” idea would not be as sound as it appeared in 1989, since the Party-State controlled economy in authoritative China will continue along with the non-liberal political system. Indeed, in one of his most recent books, Fukuyama hints that the liberal democracy, which represents the “End of History” as previous suggested, might need to be replaced by something better, combining three

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1231 Ibid
building elements, namely, the strong and effective state, the rule of law and the
democratic accountability. Evidently, the first element has been one of the main
attributes of the Chinese Consensus. To what extent the Chinese model might
incorporate the second and third element? It remains to be seen.

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1233 See further at Fukuyama, *Political Order and Political Decay: From the Industrial Revolution to the Globalisation of Democracy* (Profile Books Ltd 2014)

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