The Hostile Takeover Dilemma: Comparative Analysis and Regulatory Recommendations for China

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TO MY PARENTS

In memory of my late Grandfather

ABSTRACT

Despite China's impressive economic growth, many Chinese listed firms still suffer from weak financial performance. Corporate takeovers are often thought to be a cure for the problems of underperforming companies as they help to discipline managers *ex-ante* and allow to replace the board if it deviates from the firm's interests. The effectiveness of the market for corporate control has, however, been challenged over the years; no single theory can nowadays definitively encapsulate the nature and effects of hostile takeovers, and the various empirical studies do not lead to firm conclusions regarding their alleged benefits.

Due to the concentrated ownership structure and the lack of legal certainty, hostile takeovers currently remain a rare phenomenon in China, but it is envisaged that their number will rise in the coming years. Despite regulatory efforts, China's takeover regime remains ambiguous at times, lacking predictability, especially in the area of the role of target directors. The problem may lay in the fact that China's takeover regime has been developed through legal transplantation adopting the features of takeover regulations of both the United Kingdom and the United States, which differ substantially, particularly in their approach to the use of takeover defences by the board. This thesis investigates the current position of target directors in a takeover context, especially in the area of directors' authority to adopt anti-takeover measures, exploring the existing uncertainties and areas of concern. It strives to understand the reasons behind the shape of China's current takeover regime and attempts to assess whether the regime is suitable for China taking into account its legal, economic, political and social environment. It discovers the prevalence of type II agency problems between the controlling and minority shareholders in Chinese listed companies, which are unlikely to be solved by the monitoring and disciplining function of the market for corporate control. To the contrary, the thesis discusses risks associated with the strict 'no frustration rule' in China which tend to facilitate takeover transactions. Finally, the thesis offers reform recommendations for takeover regime which may help China to achieve its set objectives with the performance improvement of China's listed companies being amongst the most important ones.

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AAs	Articles of Association
CA	Companies Act
CGC	Corporate Governance Code
CIRC	China Insurance Regulatory Commission
CL	Company Law
CPC	Communist Party of China
CSRC	China Securities Regulatory Commission
MBR	Mandatory Bid Rule
MOFCOM	Ministry of Commerce
NPC	National People's Congress
NS	National Security
SAMR	State Administration for Market Regulation
SASAC	State Owned Asset Supervision and Administration Commission
SEC	US Securities and Exchange Commission
SL	Securities Law
SOE	State Owned Enterprise
SPC	Supreme People's Court
SSE	Shanghai Stock Exchange
SSS Reform	Split Share Structure
SZSE	Shenzhen Stock Exchange
TC	Takeover Code
TM	Takeover Measures

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CHAPTER I Introduction

Takeover regulations in mature jurisdictions have been studied extensively in the last decade. Relatively little attention, however, has been given to developing economies, especially in terms of regulation of hostile takeovers and takeover defences, despite their growing importance and practical implications.

Being the world's second largest economy, China is increasingly playing an influential role in the global economy's development.[1] Thanks to the measures taken by its regulators to modernise its laws and regulations, coupled with a gradual lessening of the administrative intervention in takeover regulations indicating a move towards a market-based approach,[2] the overall amount of mergers and acquisitions (M&As) in China has increased substantially over the past few decades. China's inbound transactions hit a record high in 2018. With 3,343 deals worth USD160,980 million, China is the second country in the world[3] most frequently targeted by foreign investors.

Despite the growth in the M&A activities, hostile takeovers in China remain a rare phenomenon.[4] Although allowed by law, such transactions have been highly restricted in China due to the widespread existence of non-tradable shares and the majority of the shares being excluded from the market.[5] The landscape of China's capital markets changed significantly following a number of reforms aimed at their modernisation. With nearly 85% of tradable shares,[6] the major factor restricting contested takeovers has now been removed. A substantial constraint in the form of highly concentrated ownership structure of China's listed companies nevertheless remained in place, effectively hampering development of an active market for corporate control. Yet, the trend of decentralisation of the ownership of state-owned enterprises (SOEs) and a growing number of entirely privately-owned companies with more dispersed shareholder structures[7] is likely to result in the increased number of hostile

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[4] Wang, *Company Law in China: Regulation of Business Organizations in a Socialist Market Economy* (Edward Elgar Publishing 2014).

[5] ibid; Yang, Chi and Young, 'A Review of Corporate Governance in China' (2011) 25 Asian-Pacific Economic Literature 15, 17.

[6] The China Securities Regulatory Commission, '2014 Annual Report' <www.csrc.gov.cn/pub/csrc_en/about/annual/201506/P020150612564204379767.pdf> accessed 16 May 2017.

[7] Lin, 'Non-Legal Protection for Minority Shareholders in China' (2012) 7 Journal of Cambridge Studies 50.

takeovers in China in the coming years, which recent takeover battles[8] appear to confirm.

Although Measures for the Administration of the Takeover of Listed Companies[9] (Takeover Measures) - which are the main source of takeover regime - established a fairly comprehensive legal regime governing takeover activities, some areas remain problematic, especially given probability of the increase in hostile takeovers in China. Ambiguity of the rules regulating the conduct of the board of directors in the context of a takeover offer, and the lack of clarity in regard to an acceptable target board's response to an unsolicited offer in particular, constitute some of the primary areas of concern. A very limited number of precedents[10] of hostile acquisitions does not provide much guidance as the decisions made by the authorities are inconsistent and vary on a case-by-case basis.[11] A high level of uncertainty caused by ambiguity of law and deficiency of a legal framework with a high degree of predictability[12] amounts to a significant risk to the acquirer, given the costs and time investment involved in the preparation and execution of hostile takeovers. Potential acquirers need certainty and predictability as to the takeover offer's procedures and expected time-frame.

1.1. Research Questions

In light of the above, this thesis aims to identify and analyse the role of the target board of directors in the context of hostile takeovers under China's takeover regulations. Particular attention will be paid to directors' authority to use takeover defences to deter unsolicited takeovers generally and to defend the company against a specific hostile acquirer. This thesis will investigate whether the provisions of Article 8 and Article 33 of the Takeover Measures governing directors' conduct during takeovers can effectively co-exist within an existing takeover regime in China. It will then question the suitability of the existing takeover regulations in relation to China's socio-legal context, including agency

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[8] Minsheng Bank and Anbang Insurance Group, CSG Holding and Baoneng Group, and Vanke and Baoneng Group. See page 155 for more details.

[9] Shangshi Gongi Shougou Guanli Banfa [Measures for the Administration of the Takeover of Listed Companies] promulgated by the CSRC, 17 May 2006 (last amended 2014).

[10] In China, which is a civil law country, an earlier court's judgement does not bind future court proceedings. 'Precedents' here refer to the prior cases of hostile acquisitions generally. According to Wei Cai until 2011 there were only 11 known hostile takeovers attempts during which the target board implemented anti-takeover measures. Such a limited number of cases provides little practical guidance in relation to the procedures and rules governing hostile takeovers and their enforcement, especially given the inconsistency in enforcement; Cai, 'Hostile Takeovers and Takeover Defences in China' (2012) 42 Hong Kong Law Journal 901.

[11] ibid 923.

[12] Due to the rapid and frequent changes to the regulatory framework, inconsistent application of rules, lack of transparency, judicial corruption and other various rule of law problems; Peerenboom, *China's Long March toward Rule of Law* (Cambridge University Press 2002) 464.

problems, ownership structure and characteristics of shareholders, the current state of China's capital markets, corporate governance arrangements and political influence on corporate affairs. Lastly, attempt will be made to understand the major objectives of China's takeover regulations and provide suitable reform recommendations for the rules governing directors conduct which may help to achieve sought objectives.

This thesis concentrates on the regulation of hostile takeovers by the means of an offer within the context of listed companies. It analyses other substantive and procedural laws and corporate governance arrangements to the extent necessary[13] to fulfil the objective of the thesis, namely, to provide reform recommendations to China. The main focus of the proposed reforms are issues directly and indirectly linked to the regulation of directors' conduct in a takeover context.

It is by no means claimed that the issues presented are the only ones that ought to be addressed within China's existing regime, however, the confines of space prevent a full examination of other, less pivotal issues.

1.2. Research Methods

This thesis uses comparative law methodology as it appears to be the most appropriate method to address the main two issues the thesis hopes to accomplish, namely: a better knowledge and understanding of the takeover regime in China, especially in relation to directors conduct in the context of a hostile takeover, and the enhancement of the latter. A comparison of selected legal systems will be carried out using Kamba's analytical framework consisting of three phases: the descriptive phase, the identification phase and the exploratory phase.[14] The first phase involves mainly doctrinal analysis and takes the form of a description of the norms, concepts and institutions of the systems under comparative consideration. The identification phase consists in the identification of differences and similarities between the systems concerned. It also involves the examination of the socio-economic problems and the legal solutions provided by the systems in question. The third stage attempts to explain divergences and similarities of the systems compared in order to draw

[13] The thesis adopts Bell's approach to comparative law which assumes embeddedness of the legal problem in the system concerned necessary, as an analysis of a specific problem without some reference to the procedural context, the organisational setting and the conceptual structure within which the rules operate, and the legal problems occur is incomplete. Bell, 'Legal Research and the Distinctiveness of Comparative Law' in Van Hoecke (ed), *Methodologies of Legal Research: Which Kind of Method for What Kind of Discipline* (Hart Publishing 2013).

[14] Kamba, 'Comparative Law: A Theoretical Framework' (1974) 23 International and Comparative Law Quarterly 485, 511.

conclusions.[15] Using this framework helps structuring the analysis in order to achieve clarity and focus.

Comparative law will lead to better awareness and understanding of the norms and institutions of the law in China; by opposing the latter to the corresponding norms and institutions of foreign laws, comparative law shows them in a mirror which reveals characteristics which were not necessarily obvious at first. The main benefit of comparative method is that it allows observation of how similar dilemmas work out in different legal contexts. In cases where the possibility of experimentation is limited, the understanding of solutions implemented in foreign countries can limit, to a certain extent, the need of direct experimentation in order to improve domestic law.[16]

The takeover regimes of the United Kingdom (UK) and the United States (US) have been selected as analysis samples for this thesis. China's modern legal system has been developed mainly through legal transplantation, that is, by borrowing rules and regulations from other jurisdictions.[17] The legal systems of the UK and the US constituted the main source of inspiration for China's regulators in the corporate and securities regimes. In fact, China's existing takeover regulation has been largely developed through a direct transplantation of various provisions within the Takeover Measures, adopting a blend of the UK and the US systems of takeover regulation.[18] Moreover, it should be noted that the UK's Takeover Code has also been indirectly influential in China, since Chinese takeover regulation was in part also originally modelled upon the Hong Kong law, which itself was transplanted from the UK's tradition.[19]

It is therefore critical to analyse the regulatory approach of these two jurisdictions to hostile takeover regulation with the aim of obtaining a better understanding of the issues within the existing regulation and practice of takeovers in China. Moreover, as the thesis involves proposing reforms to the Chinese system, it may prove beneficial to draw from the experiences of the UK and the US since these jurisdictions are believed to have the most comprehensive takeover regimes in the world, often considered to be superior in relation to other

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[15] ibid

[16] Zajtay, 'Aims and Methods of Comparative Law' (1975) 3 The Comparative and International Law Journal of Southern Africa 321 (n) 322.

[17] Chen, *Regulating the Takeover of Chinese Listed Companies: Divergence from the West* (Springer 2014) 3.

[18] Article 8 generally borrows from the US model; Article 33 draws upon the UK model (both directly and indirectly through Hong Kong regulations) in relation to the application of some selected defensive measures.

[19] Yu, 'Does One Size Fit All? Transplanting English Takeover Law into China' in *Corporate Governance: Does Any Size Fit?* (Emerald Group Publishing Limited 2005) 50.

systems.[20] This perhaps explains why they so often serve as model regulations to other jurisdictions[21]. Last but not least, the regulatory approach to takeover defences adopted by the UK and the US differs substantially, which will facilitate observation of the regulation of directors' conduct in a takeover context from two very different perspectives. At the same time, it is worth noting that despite those fundamental differences, both jurisdictions are characterised as two of the most active markets for corporate control in the world,[22] which is of substantial importance since facilitating M&A transactions has been considered by the regulators as one of the key objectives of China's takeover regulations.[23]

In order to understand the broader context in which the law is placed and to mitigate the problem associated with putting too much reliance on mono-functionality and effectiveness of legal norms and institutions, this thesis will briefly account, where applicable, for non-legal elements such as socio-economic and cultural differences between selected jurisdictions.[24] While engaging in the study of a legal transplant it is particularly crucial to be alert to such issues as technical incompetence and lack of effective enforcement.[25] This proves to be of great relevance in the context of this research, as many empirical studies confirm the existence of significant discrepancies between 'law in books' and 'law in action' in China.[26] Thus, given that a socio-legal approach is believed to be of particular value, especially when the main objective of the research is explaining the law and/or forwarding recommendations for its reform, the comparative method of this thesis involves the study of institutional administration of law as well as economic, social, political and cultural settings of the legal systems analysed, including listed firms' ownership structure, the current state of countries' capital markets, their corporate governance and other factors.

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[20] Goergen, Martynova and Luc, 'Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe' (2005) 21 Oxford Review of Economic Policy 243.

[21] Such as Hong Kong, Korea, Japan, Singapore and India. For more detailed analysis of the takeover regimes of the mentioned jurisdictions see Varottil and Wan, 'Hostile Takeover Regimes in Asia: A Comparative Approach' NUS Law Working Paper No 2018/011.

[22] Davies, Hopt and Ringe, 'Control Transactions' in Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3 edn, Oxford University Press 2017) 206.

[23] For further discussion on the objectives of China's takeover regulations see Part 5.2.

[24] Michaels, 'The Functional Method of Comparative Law' in Reimann and Zimmermann (eds), *The Oxford Handbook of Comparative Law* (Oxford University Press 2006) 351.

[25] Nelken, 'Comparative Law and Comparative Legal Studies' in Örücü and Nelken (eds), *Comparative Law: A Handbook* (Bloomsbury Publishing 2007) 20.

[26] Chen, Li and Otto, *Implementation of Law in the People's Republic of China* (Kluwer Law International 2002) 2-5; Chen (n17).

1.3. Original Contribution

Although China's takeover regulations have received some attention from the academic community, literature specifically concerning the regulation of takeover defences has traditionally been rather limited. Yet, since the start of this research project, the subject matter of the thesis has received an unprecedented attention (one monograph,[27] one book chapter in edited volume[28] and two completed PhD dissertations[29]) which makes an original contribution relatively challenging. Nevertheless, despite adopting the comparative method and selecting the same jurisdictions for comparison purposes, each of these works deal with the same matter from a different angle. Moreover, what distinguishes this thesis from the previous studies is the approach towards reform recommendations. While previous studies typically insist on a strict legal transplant of one of the two models analysed,[30] this thesis embraces a holistic approach arguing that neither of the systems is currently suitable to be fully adopted in China. A fundamental reform of substantive law regulating directors conduct in a takeover context will likely be ineffective if China first does not address the problems associated with concentrated ownership and weak enforcement of certain provisions of its takeover regime. The focus of this thesis is on addressing areas of concern of the existing regime related to directors' use of takeover defences in a piecemeal fashion rather than a wholesome reform with a special emphasis on strengthening independence of the board and clarifying the existing rules and strengthening their enforcement.

Finally, this thesis engages in the analysis of a broad range of issues, including other areas of law, corporate governance and market-led arrangements, in order to tackle the identified problems in China's directors' duties regime in a takeover context and to find a way to fulfil the objectives set by China's regulators in respect of takeovers which the takeover market alone is not able to achieve given the existing socio-legal context.

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[27] Chen (n17).

[28] Huang and Chen, 'Takeover Regulation in China: Striking a Balance between Takeover Contestability and Shareholder Protection' in Varottil and Wan (eds), *Comparative Takeover Regulation: Global and Asian Perspectives* (Cambridge University Press 2017) 227.

[29] Liu, 'A Comparative Study of Takeover Defences in Uk, Us and Chinese Law' (DPhil thesis, Durham University 2016); Wang, 'Takeover Law in the Uk, Us and China: A Comparative Analysis and Recommendations for Chinese Takeover Law Reform' (DPhil Thesis, University of Salford Law School 2013).

[30] See, eg Cai (n10) (proposing a prohibition of post-bid defences unless approved by the 2/3rd of shareholders); Chen (n17) (recommending expanding the board neutrality rule in China but also providing for shareholders veto right); Varottil and Wan (n21) (proposing adopting strict board neutrality rule).

1.4. Structure of the Research

This thesis primarily concerns regulation of the conduct of a board of directors of a target company in a context of hostile takeovers, with a focus on the possibility of adoption of selected anti-takeover measures. As such, the thesis is organised with the following structure. Chapter 1 outlines the main issues to be addressed and identifies the methodology used to assist in answering the underlying questions in this thesis. A discussion on causes, efficiency and impact of hostile takeover activities included in Chapter 1 provides a theoretical and conceptual foundation for analysis of the selected takeover regimes and potential reform recommendations for China. Chapters 2 and 3 present regulations governing the conduct of directors in a takeover context in the US and the UK respectively, mainly applying a doctrinal method. Chapter 4 provides an overview of the China's legal system to better understand the process of law making in China and factors influencing its legal system to provide feasible reform recommendations. Chapter 5 outlines and analyses the existing takeover regime in China mainly focusing on 'law in books'. Chapter 6 contextualises the analysis of the current state of takeover regulations in China. Drawing on the comparative analysis of the US and the UK takeover regulations, it discusses and evaluates the possible areas of concern within the existing regime. The final part of the chapter examines the effects, the pros and cons of each regime's approach towards adoption of anti-takeover measures. Finally, chapter 7 concludes the thesis evaluating a possibility of direct transplantation of analysed regimes to China. The chapter puts forward a reform proposal based on the objectives of China's takeover regulation and in a manner consistent with the comparative view.

1.5.Theoretical and Conceptual Background

1.5.1. Terminology

A 'takeover' is a general term referring to a transfer of control of a company from one shareholder or a group of shareholders to another, which may occur via a tender offer (a direct appeal to shareholders to sell their shares that does not require the approval of the target's board of directors[31]). In contrast to friendly takeovers, when the acquirer's offer receives a positive response from the target's board of directors, hostile bids are unsolicited offers which often challenge the strategic direction and leadership of the company and are opposed

[31] The term 'tender offer' in the UK has a narrower meaning and refers to a contractual cash offer regulated by the Takeover Code which has a simplified procedure and usually is used to purchase no more than 30% of the company's issued shares. TC, app5.

by the target's board.[32] The focus of this thesis is on hostile takeovers of listed companies via an offer.

Takeover defences are measures used by the company to stop, delay or make it more difficult for the bidder to acquire control of the firm. Takeover defences can be divided into two categories: preventive (pre-bid) and reactive (post-bid). Preventive mechanisms are strategies employed by the board of directors to make the company less attractive as an acquisition target. Reactive defence strategies are activated in response to a specific bid by an unwelcome acquirer.[33]

The pre-bid measures discussed in this thesis in greater detail include shareholder rights plans (US style 'poison pills')[34], 'shark repellents' and 'golden parachutes'. A shareholder rights plan is a defensive measure in which the shareholders of the target firm are given 'rights', which are not immediately effective, but can be redeemed in the future, to purchase shares in the target (poison pill with flip-in options) at a highly discounted rate in case of some triggering event (e.g. the announcement of a takeover, increased activity on the open market, acquiring a pre-specified percentage of the company's equity by a single investor or a group of investors acting in concert).[35] The logic behind the adoption of a US style-poison pill is to dilute the unwelcome suitor's economic interest and voting power in the target and prevent it from acquiring enough shares to take control of the firm.[36] The poison pill creates a barrier to share accumulation beyond a certain threshold of ownership - usually 10% to 15%.

'Shark repellents', i.e. inclusion of entrenchment provisions in a company's constitutional documents which makes taking over the company more difficult, constitute another common measure against hostile takeovers. Some shark repellents take the form of weighted voting rights (WVR) given to certain shareholders, others provide for staggered terms of directors' office, or impose other types of impediments to hostile takeovers.[37] A staggered board involves arranging terms of elections of the directors to the board so that not all of them are elected during the same year. Since an acquirer is required to wait for a

[32] Jenkinson and Mayer, *Hostile Takeovers: Defence, Attack and Corporate Governance* (McGraw-Hill Publishing 1994) 6.
[33] Ruback, 'An Overview of Takeover Defenses' in Auerbach (ed), *Mergers and Acquisitions* (University of Chicago Press 1987).
[34] In the UK the term 'poison pill' often refers generally to defensive measures which subject the target company to adverse financial consequences. See eg *Criterion Properties Plc v Stratford UK Properties LLC* [2002] EWHC 496 (Ch).
[35] Subramanian, 'Bargaining in the Shadow of Takeover Defenses' (2003) 113 The Yale Law Journal 621, 625.
[36] Pearce II and Robinson Jr, 'Hostile Takeover Defenses That Maximize Shareholder Wealth' (2004) 47 Business Horizons 15, 16-17.
[37] Knoeber, 'Golden Parachutes, Shark Repellents, and Hostile Tender Offers' (1986) 76 The American Economic Review 155, 156.

certain number of consecutive annual meetings before it can replace the incumbent directors, this tactic prevents an acquirer from a timely facilitation of the transition in the aftermath of the takeover[38] and acts to lower the possibility to conduct the company's affairs in a way not approved to by the target board.[39]

Finally, a 'golden parachute' is an agreement providing extensive monetary awards to an executive director who is forced to leave the company in the event of a change of control.[40] Golden parachutes may have an effect of deterring takeovers since the acquirer is forced to spend a substantial amount of money to settle the obligation. At the same time, the rationale for allowing the adoption of a golden parachute is an assumption that a generous exit package would help to align directors' actions with the interests of shareholders and keep them from obstructing potentially value-enhancing offers.[41]

Post-bid takeover defences allow the board of the target to adopt certain measures in response to a specific bid. The most widely used proactive defence strategies include tactical litigation, finding a 'white knight', 'crown jewel' defence and capital structure changes. In regard to post-bid defences, this thesis will discuss the general availability of such defences, rather than discussing each separately. Special attention will nevertheless be paid to tactical litigation and a white knight defence. Tactical litigation can be described as legal proceedings initiated by the company that is subject to a hostile takeover bid with a view to delay or frustrate the bid.[42] The white knight defence involves solicitation of a friendly third party supported by the target board which acquires the company or buys sufficient shares allowing it to block the unwelcome bidder.

1.5.2. Causes and Effects of Takeovers

In a modern company characterised by a separation of ownership and control,[43] the company's nominal owners, the shareholders, do not exercise exclusive management and control rights over its everyday operations and long-term strategies. Instead, professional executives, who usually own only a small fraction of the company's equity, typically control its operations and policies.[44]

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[38] Pearce II and Robinson Jr (n36) 19.
[39] Knoeber (n37) 156.
[40] ibid 156.
[41] Fiss, 'A Short History of Golden Parachutes' (*Harvard Business Review*, 03 October 2016) <hbr.org/2016/10/a-short-history-of-golden-parachutes> accessed 23 November 2016.
[42] Ruback (n33) 63-64.
[43] The separation of ownership and control characteristic is typical only of large public companies listed on regulated markets. This research focuses on listed firms because of their likelihood of becoming the subject of a takeover bid.
[44] Berle and Means, *The Modern Corporation and Private Property* (Legal Classics Library 1993).

Thus, the separation of ownership and control is associated with 'agency costs'[45] because the executives responsible for crucial operating decisions are not residual claimants[46] and, thus, do not reap a major share of the wealth effects of their decisions.[47] Since both parties in a principal-agent relationship are utility maximisers, an agent will not always act in the best interest of a principal.[48] Without an effective system of control, executives are likely to take actions deviating from the interests of residual claimants. Berle and Means[49] claim that a decentralised system of shareholders cannot suitably constrain executives to act in the best interests of the company. In the situation where executives do not directly bear the economic consequences of their actions and are not fully accountable for their conduct, they may choose to expropriate a part of the company's wealth which will prejudice the principal's welfare.

According to Jensen and Meckling,[50] establishment of appropriate incentives for the agent and monitoring activities of the agent's conduct can limit the agent's deviations from the principal's interests. The monitoring activities include internal mechanisms such as monitoring by the board of directors and shareholders[51] as well as monitoring by external instruments, such as capital markets, banks, legislators and the market for corporate control. External monitoring plays a crucial role in public companies since dispersed shareholders cannot effectively monitor executives due to coordination problems. The market for corporate control is believed to limit agency costs both indirectly (the threat of takeovers) and directly (by replacing underperforming executives following a successful takeover).

The fundamental basis underlying the takeover market is the existence of a positive correlation between the firm's share price and the performance of its executives. It is believed that objective share prices provide a third-party, unbiased assessment of managerial actions[52] through the movement of prices allowing shareholders to receive instant feedback regarding the company's performance. Rational investors, aware of executives' incentives to engage in

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[45] The agency problem arises where 'an agent' – in this case an executive director - acts for, or, on behalf of the other party, 'a principal', in this case the shareholders, in a particular domain of decision problems.
[46] Those only entitled to profit left after the company's contractual obligations have been met.
[47] Fama and Jensen, 'Separation of Ownership and Control' (1986) 26 Journal of Law and Economics 301.
[48] Jensen and Meckling, 'Theory of the Firm : Managerial Behavior , Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305, 309.
[49] Berle and Means (n44).
[50] Jensen and Meckling (n48) 309.
[51] Where shareholders would either approve or dismiss important managerial decisions by voting.
[52] Holmström and Tirole, 'Market Liquidity and Performance Monitoring' (1993) 101 Journal of Political Economy 678, 708; Manne, 'Mergers and the Market for Corporate Control' (1965) 73 Journal of Political economy 110.

self-benefiting activities at the expense of the company, make impartial estimates of the costs associated with such conduct, in the form of a corresponding decline in the price they are willing to pay for the company's shares. Executives, aware that their decisions are being constantly assessed by the market, are under pressure to positively influence market perceptions by reducing self-benefiting and non-value maximising activities.[53] In addition, share prices also measure the potential capital gain inherent in the company shares.[54] The lower the firm's share price, in comparison to what it could have been with more efficient board,[55] the more attractive a takeover becomes to those bidders who think optimum corporate performance can be restored by better use of the company's assets by new directors elected after the acquisition.[56]

An actual takeover is often not even necessary - a threat of a takeover alone can serve as a disciplining mechanism. Putative bids help to decrease agency costs *ex-ante* since the executives of a poorly performing company can expect an acquirer to appear trying to take control of the company, which may result in their dismissal following a successful acquisition.[57] As a result, they are likely to change their strategy, or otherwise be replaced, which benefits shareholders in the form of better performance in the future.[58] A great advantage of the market for corporate control is, therefore, the fact that it is self-effectuating, meaning that it 'emerges spontaneously from market forces without the need for any action taken or resources deployed on the part of the subject company'.[59] Target shareholders do not need to spend their own resources on monitoring executives, yet they benefit from less divergence of executives from the interest of the company.

Whilst theory suggests that a company becomes a target of a takeover when it is inefficiently managed, and thus significantly undervalued (one may, therefore, expect targets to be less profitable than average companies in the industry), the empirical evidence does not always support this presumption. A number of studies[60] did not find target underperformance prior to the bid. Even within a

[53] Fama and Jensen (n47) 313.
[54] Manne (n52) 113.
[55] For example, when it is significantly lower in comparison to its industry competitors.
[56] Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2010) 119.
[57] Easterbrook and Fischel, 'The Proper Role of a Target ' S Management in Responding to a Tender Offer' (1981) 94 Harvard Law Review 1161, 1174.
[58] Lynch and Musto, 'How Investors Interpret Past Fund Returns' (2003) 58 The Journal of Finance 2033, 2038.
[59] Macey (n56) 121.
[60] See eg Agrawal and Jaffe, 'Do Takeover Targets Underperform? Evidence from Operating and Stock Returns' 38 Journal of Financial and Quantitative Analysis 721; Matsusaka, 'Target Profits and Managerial Discipline During the Conglomerate Merger Wave' (1993) 41 Journal of Industrial

subsample where disciplining the board was indicated as the most likely motive for a takeover, Agrawal and Jaffe [61] could not find strong evidence of underperformance. Rhodes-Kopf and Viswanathan[62] reported that many of the takeovers took place even in the absence of underlying reasons for acquisition, as they were largely driven by overvaluation. At the same time, some potentially beneficial and much needed takeovers never take place due to the 'feedback effect' - a combination of the 'trigger effect' and the 'anticipation effect' - first, underperformance of a company triggers the possibility of intervention which drives the share price of the potential target up prior to an anticipated acquisition which may in the end stop the acquirer from taking over an underperforming target because it becomes too expansive.[63]

The theory of the disciplining role and value-enhancing effect of takeovers is quite difficult to test in practice. While hostile takeovers generally benefit the target shareholders thanks to the payment of premium above the shares' market price, [64] benefit to the shareholders of the acquiring company is often negligible.[65] According to Rolls, such results may at least partially be explained by a simple transfer of wealth from the acquiring company to the target shareholders - the observed takeover premium represents an overstatement of the expected increase in economic value of the post-acquisition entity.[66] The empirical evidence shows that many takeovers do not produce the expected value increase,[67] and some even appear to result in its significant reduction.[68]

Economics 179, 184 ; Ravenscraft and Scherer, 'The Profitability of Mergers' (1989) 7 International journal of industrial organization 101.

[61] Agrawal and Jaffe (n60) 721.

[62] Rhodes-Kropf and Viswanathan, 'Market Valuation and Merger Waves' (2004) 59 The Journal of Finance 2685.

[63] Edmans, Goldstein and Jiang, 'The Real Effects of Financial Markets: The Impact of Prices on Takeovers' 67 The Journal of Finance 933.

[64] Jensen, 'The Free Cash Flow Theory of Takeovers: A Financial Perspective on Mergers and Acquisitions and the Economy.' in Browne and Rosengren (eds), *The Merger Boom* (Federal Reserve Bank of Boston 1987); Jensen, 'Takeovers: Folklore and Science' (1984) 11 Harvard Business Review; Martynova and Renneboog, 'Mergers and Acquisitions in Europe' ECGI - Finance Working Paper No 114/2006 13, 7; Weston, Mitchell and Mulherin, *Takeovers, Restructuring, and Corporate Governance* (2004) 534.

[65] Jensen, 'The Free...' (n64); Martynova and Renneboog (n64) 7.

[66] Roll, 'The Hubris Hypothesis of Corporate Takeovers' (1986) 59 The Journal of Business 197, 198.

[67] For further discussion, see Gregory, 'An Examination of the Long Run Performance of Uk Acquiring Firms' (1997) 24 Journal of Business Finance & Accounting 971; Ghosh, 'Does Operating Performance Really Improve Following Corporate Acquisitions?' (2001) 7 Journal of Corporate Finance 151; Louis, 'Earnings Management and the Market Performance of Acquiring Firms' (2004) 74 Journal of financial economics 121.

[68] Maher and Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' [1999] Organization for Economic Growth and Development 3, 37 ; Akbulut, 'Do Overvaluation-Driven Stock Acquisitions Really Benefit Acquirer Shareholders?' (2013) 48 Journal of Financial and Qualitative Analysis 1025, 1053 ; Song, 'Does Overvaluation Lead to Bad Mergers ? Does Overvaluation Lead to Bad Mergers ?' (2007) AFA 2007 Chicago Meetings Paper 513; Fu, Lin and Officer, 'Acquisitions Driven by Stock Overvaluation: Are They Good Deals?' (2013) 109 Journal of Financial Economics 24 (reporting general lack of value creation for the shareholder with some acquisitions actually destroying it in both in the short and long run).

The studies by Firth[69] and Scherer[70] both confirmed that there are no significant long-term improvements in companies' profitability following successful takeovers. Firth noted that many target shareholders gained from the acquisitions, but there was no increase in the underlying profitability of the companies.[71]

On the other hand, Healy, Palepu and Ruback found that operating cash flow returns increased after acquisitions as a result of improvements in asset productivity, most likely because the suboptimal policies pursued prior to the transaction were eliminated after the deal was completed or because there were new opportunities to use the existing resources of the combined companies.[72] Shareholders are believed to be generally indifferent to these results because although acquiring shareholders lose in such transactions, the target shareholders gain what they lose and since many shareholders are well-diversified they often receive the aggregate gain, which may be close to zero,[73] provided that the costs of takeovers remain relatively small. This, however, is not always the case as takeovers consume lots of resources and may be very expensive. Significant costs are involved throughout the takeover process, starting with the cost of collecting information about the possible target and the cost of raising funds to finance the acquisition, proceeding with the administrative and legal expenses incurred by the bidder (and possibly a target, especially in case of a hostile takeover, and even more so, litigation), finishing off with the cost of the company's reorganisation following a successful bid.[74] For example, the financial fees only of the US Steel/Marathon Oil deal and the infamous Texaco/Getty takeover were approximately USD 27 million and USD 47 million respectively.[75] Consequently, Sherer considers the increased activity of the takeover market as disruptive and imposing costs and risks on the economy with no certain benefits and thus likely to be wasteful in the macroeconomic sense.[76] One should, however, note that empirical studies focus on the effect of actual takeovers, which cannot properly account for the value created through a

[69] Firth, 'Takeovers, Shareholder Returns, and the Theory of the Firm' (1980) 94 The Quarterly Journal of Economics 235.
[70] Scherer, 'Corporate Takeovers: The Efficiency Arguments' (1988) 2 Journal of Economic Perspectives 69.
[71] Firth (n69).
[72] Healy, Palepu and Ruback, 'Does Corporate Performance Improve after Mergers?' (1992) 31 Journal of Financial Economics 135, 161.
[73] Roll (n66) 214; Firth (n69) 252.
[74] Grossman and Hart, 'Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation' (1980) 11 The Bell Journal of Economics 42, 53.
[75] Jensen, however, contrasts those costs with the value of the transactions and gains obtained by the shareholders. Jensen, 'Takeovers: Folklore...' (n64).
[76] Scherer (n70) 77-81 .

disciplining effect, since the theory is greatly based on the threat of a possible acquisition, which is difficult to measure if it remains unrealised.[77]

There are several explanations why not all takeovers enhance value for the shareholders. Firstly, the effect of a takeover often depends on the motives driving the executives of the acquiring companies. Not all hostile takeovers are driven by profit maximisation as the theory assumes. Many acquirers engage in takeover activities simply because they are overvalued by the stock market and they seek to take advantage of this overvaluation through takeover activities using equity financing.[78] Some takeovers are driven by ill, typically self-benefiting incentives of the executives. Since the managerial labour market rewards those who can grow the business rapidly, and the easiest way to achieve such growth is through M&A activities, executives often choose to engage in takeovers over slower organic growth even if such takeovers do not necessarily enhance value in the long term.[79] Executives of companies with unused borrowing power and large free cash flows may engage in acquisitions to spend cash instead of distributing it to shareholders, especially in industries with limited internal investment opportunities.[80] In addition, psychological rewards and remuneration incentives associated with managing a large corporation often result in deliberate corporate 'empire building'[81] and, as such, constitute yet another motive behind many of takeover activities.

Behavioural economists further suggest to relax the assumption of managerial rationality, claiming that executives make cognitive errors either in bidding for another firm or in responding to a takeover offer.[82] Roll's hubris hypothesis predicts that executives of large acquirers are more prone to overconfidence and often pay too much for their targets.[83] A study by Moeller, Schlingemann and Stulz confirms Roll's 'hubris-inspired bids' hypothesis.[84] Further, Malmedier and Tate's empirical research reports that overconfident CEOs more often engage in takeovers and that the abnormal returns of such transactions are lower

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[77] Röller, Stennek and Verboven, *Efficiency Gains from Mergers (Working Paper No. 543)* (Stockholm: The Research Institute of Industrial Economics, 2000) 19-20.
[78] The empirical evidence reporting the effect of such takeovers in the long-term is mixed. See eg Rhodes-Kropf and Viswanathan (n62) 2710 ; Savor and Lu, 'Do Stock Mergers Create Value for Acquirers?' (2009) 64 The journal of finance 1061 ; Shleifer and Vishny, 'Stock Market Driven Acquisitions' 70 Journal of Financial Economics 295 (arguing that acquisitions for stock are in the long-term interest of the acquirer's shareholders, even if the returns are negative because the returns are just not as negative as they would have been in the long run without the acquisition).
[79] Firth (n69) 254-8.
[80] Jensen, 'The Free...' (n64) 130-1.
[81] Langevoort, 'The Behavioral Economics of Mergers and Acquisitions' (2011) 12 Transactions: The Tennessee Journal of Business Law 65.
[82] ibid
[83] Roll (n66) 199-212.
[84] Moeller, Schlingemann and Stulz, 'Firm Size and the Gains from Acquisitions' (2004) 73 Journal of Financial Economics 201, 201-226.

than for those conducted by the non-overconfident CEOs. [85] It is worth stressing that, unlike in the previously mentioned motives, executives engaging in M&A activities due to overconfidence often genuinely believe that they are acting in the interest of the company/shareholders.

Another possible explanation of the mixed empirical evidence in respect of effects of takeovers lies in the fact that the disciplining role of takeovers and subsequent improvement in economic efficiency are based on the assumption of efficient capital markets that accurately value companies' shares and identify inefficiently managed companies. [86] However, capital markets are almost certainly not as efficient as the theory regarding the disciplining role of takeovers originally assumes. According to the efficient market hypothesis, the current share prices at any time fully reflect all available information.[87] When trying to assess how efficient capital markets are in reality, one must measure how fully and how fast information is incorporated into the share price. Fama categorised the degree of information reflected in share prices into three forms of efficiency: weak form, semi-strong and strong form. Weak form asserts that the market reflects all historical prices; semi-strong form states that share prices reflect all the information that is currently publicly available, whilst strong form postulates that share prices incorporate all 'knowable'[88] information.[89]

It is difficult to precisely assess the real extent of deviation of the actual share prices from their fundamental value. According to Fama, Jensen and Roll, investors very quickly react to new information on the market which is reflected in a prompt adjustment of the share price.[90] Neuhierl, Scherbina and Schlusche, however, argue that the assumption of the stock market always rapidly quantifying the impact of information on share prices is unrealistic, and report that information realised by the companies typically reaches the market after a substantial delay.[91] Having noted that share prices react sluggishly to relevant

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[85] Malmendier and Tate, 'Who Makes Acquisitions? Ceo Overconfidence and the Market's Reaction' (2008) 89 Journal of financial Economics 20.
[86] Jensen and Ruback, 'The Market for Corporate Control: The Scientific Evidence' (1983) 11 Journal of Financial economics 5; Goergen, Manjon and Renneboog, 'Recent Developments in German Corporate Governance' (2008) 28 International Review of Law and economics 175.
[87] Fama, 'Random Walks in Stock Market Prices' (1965) 21 Financial Analysts Journal 55, 56.
[88] 'Knowable' information includes private information, historical prices and publicly available information.
[89] Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 Journal of Finance 383, 383-84.
[90] Fama and others, 'The Adjustment of Stock Prices to New Information' (1969) 10 International economic review 1.
[91] Neuhierl, Scherbina and Schlusche, 'Market Reaction to Corporate Press Releases' (2013) 48 Journal of Financial and Quantitative Analysis 1207, 1208 (the information, however, could have been already partially incorporated in the share price at the time of the official disclosure to the public because some market participants such as analysts and investment funds benefit from selective information disclosure).

information, Hirshleifer, Liam and Teoh observed that the response is weaker and slower when a greater amount of information is released on the same day.[92]

When assessing the effect of takeovers, the majority of studies focus solely on the position of shareholders by measuring the premium paid to the target shareholders and post-acquisition changes in share price. Sources of these gains are rarely indicated. Such an approach may not provide a true picture of the impact of takeovers because it is not irrelevant where the gains came from: whilst gains generated by synergies are beneficial at the macro level, those coming from tax avoidance, increased monopoly rents, transfers from employees or other non-shareholder stakeholders may not necessarily be so. Understanding the sources of equity gains is therefore crucial for the debate on takeovers' desirability and regulatory approach towards takeovers. Debate should hence not be limited to the shareholders' wealth but should also include the effect of takeovers on the economy as a whole and on other constituencies.

Takeovers are believed to positively influence economic performance through increased allocation efficiency as they help to ensure that the existing resources are used in the most profitable way.[93] More productive companies can produce a higher level of output using a given amount of resources, which translates to a larger gain in the value from the assets they control. Thus an optimal allocation of resources involves transfer of assets from less productive controllers.[94] Takeovers facilitate such transfer either directly[95] or indirectly by instituting changes in the company's board which assure better use of the target's resources.[96] Yet, since there are considerable costs associated with takeovers,[97] unless the assets are *in fact* used more efficiently post-acquisition, there is no real gain coming from the transfer of the ownership of existing assets while real resources are being wasted in the process.

Operational and financial synergy gains constitute another source of value created by the takeovers since the combined firms are able to generate greater

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[92] Hirshleifer, Lim and Teoh, 'Driven to Distraction: Extraneous Events and Underreaction to Earnings News' (2009) 64 The Journal of Finance 2289, 2323.
[93] Cosh, Hughes and Singh, 'Takeovers and Short-Termism in the Uk' [1990] Industrial Policy Papers No 3 Institute for Public Policy Research.
[94] Maksimovic and Phillips, 'The Market for Corporate Assets: Who Engages in Mergers and Asset Sales and Are There Efficiency Gains?' (2001) 56 Journal of Finance 2019, 2021.
[95] By selling off the assets by the acquirer to those who can use them in the most productive way. Divestiture constitutes a critical part in the market for corporate control. Divested assets do not disappear, they are simply reallocated. See Jensen, 'The Free...' (n64) 108.
[96] Bebchuk, 'The Case for Facilitating Competing Tender Offers: Comment' (1982) 95 Harvard Law Review 1028, 1031.
[97] See page 13.

profit than the target and acquirer separately.[98] It can be achieved through, e.g., complementarities in the post-acquisition entity where combined production, marketing and technological base (involving R&D transfer and process know-how) help to push down the costs.[99] In the long term, innovation can quicken the pace of technological development and contribute to greater efficiency, lower costs, higher levels of economic activity and ultimately to a faster rate of growth.[100] However, not all takeovers motivated primarily by synergetic gains are in reality value-enhancing. The studies reporting significant value increase through operational or financial synergies are infrequent,[101] while many of the studies[102] report no or minimal synergetic gains following the acquisition. Even the study that focuses solely on horizontal transactions (which are supposed to provide maximum opportunity for synergetic gains) concludes that only half of the sample studied realised medium to high gains, while the other half achieved no or very little gain.[103] Whether or not synergy gains are realised depends on a range of factors, including quality of planning,[104] combination potential and level of employees' resistance[105]. Yet, a recent report by PwC, one of the world's biggest professional services' firms, indicated that an approach employed by a substantial number of companies during the valuation of prospective takeovers is likely to account for inaccurate synergy estimates or cause the valuation team to assess factors that are not relevant to the valuation model. [106] The extent of such practice constitutes a cause for concern, since, as just pointed out, quality of planning and adequate identification of combination potential represent some of the key factors determining a deal's success.

Takeovers may prove helpful in imperfect product markets characterised by limited competition. Lack of effective disciplining forces allows company's executives to diverge from profit maximisation which leads to decreased

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[98] Romano, 'A Guide to Takeovers: Theory, Evidence and Regulation' (1992) 9 Yale Journal on Regulation 119, 131-2.
[99] Ravenscraft and Scherer, *Mergers, Sell-Offs, and Economic Efficiency* (Brookings Institution Press 1987) 3.
[100] Fikri, 'Review of the Evidence on Growth of Companies and Economies of Scale' in Samuels (ed), *Readings on Mergers and Takeovers* (St. Martin's Press 1972) 292-293.
[101] See eg Huyghebaert and Luypaert, 'Sources of Synergy Realization in Mergers and Acquisitions: Empirical Evidence from Non-Serial Acquirers in Europe' (2013) 4 International Journal of Financial Research 49 (reporting both operating and financial synergies).
[102] Cowling and others, *Mergers and Economic Performance* (Cambridge University Press 1980) 160-66; Gregory (n67) 971-1002; Ghosh (n67) 151; Louis (n67) 121.
[103] Caves, 'Effects of Mergers and Acquisitions on the Economy : An Industrial Organization Perspective' in Browne and Rosengren (eds), *The Merger Boom* (Federal Reserve Bank of Boston 1987) 157.
[104] Kitching, 'Why Do Mergers Miscarry?' (1967) 45 Harvard Business Review 84, 89.
[105] Larsson and Finkelstein, 'Integrating Strategic, Organizational, and Human Resource Perspectives on Mergers and Acquisitions: A Case Survey of Synergy Realization' (1999) 10 Organization science 1.
[106] PwC, 'How Synergies Drive Successful Acquisitions. Identifying, Realising and Tracking Synergies in the M&A Process.' (2010) <http://www.pwc.com/us/en/transaction-services/assets/how-synergies-drive-successful-acquisitions.pdf> accessed 10 December 2014.

productive efficiency[107] and increased internal slack of management (sometimes called X-inefficiency)[108]. An active market for corporate control can substitute, to a certain extent, for competition in a product market because it forces executives to focus on profit maximisation otherwise the company is at risk of becoming a takeover target. Whereas the threat of being taken over may prove beneficial in imperfect product markets, actual takeovers may negatively impact the market structure. In fact, a dominant motive behind some transactions, in particular, horizontal mergers, is an increased market power[109] which would allow the resulting entity to benefit primarily at the expense of consumers through, e.g., higher products' prices. Even if the company's performance is enhanced as a result of such tactic after the takeover, part of the gains represent transfer of wealth from consumers to shareholders, thus takeovers motivated or resulting in an increased market power typically do not represent any welfare gains, but often actually decrease the welfare of the concerned economy.

Generally, much public concern has been expressed in recent years in regard to the impact of hostile takeovers on the welfare of the non-shareholder stakeholders. On the other hand, both theoretical and empirical studies on the impact of takeovers typically only focused on the net gains of the target and the acquirer measured in terms of shareholder value, thus the effect on other stakeholders was often ignored. Using the Kaldor-Hicks criteria, a particular takeover is efficient if the gains of one party exceed the losses incurred by the other party. [110] All kinds of stakeholders including employees, suppliers, consumers, and local communities, not just shareholders, may be influenced, either directly or indirectly, by takeovers. [111] Those [112] who contemplate a broader set of constituencies recognise that changes in corporate control very often negatively affect the interests of said constituencies.

[107] Productive efficiency means that output is maximised by using the most effective combination of inputs.

[108] Röller, Stennek and Verboven (n77) 19; Adams, 'Should Merger Policy Be an Antitrust Perspective Changed?' in Browne and Rosengren (eds), *The Merger Boom* (Federal Reserve Bank of Boston 1987) 177-83.

[109] Green and Cromley, 'The Horizontal Merger: Its Motives and Spatial Employment Impacts' (1982) 58 Economic Geography 358, 360.

[110] Enriques, Gilson and Pacces, 'The Case for an Unbiased Takeover Law (with an Application to the European Union)' (2014) 4 Harvard Business Law Review 85, 91.

[111] For a detailed discussion of the impact of takeovers on various stakeholders and the adequacy of stakeholder's contractual protection, see Daniels, 'Stakeholders and Takeovers: Can Contractarianism Be Compassionate?' (1993) 43 The University of Toronto Law Journal 315.

[112] Aguilera and Jackson, 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants' (2003) 28 Academy of Management Review 447; Blair and Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Virginia Law Review 248 ; Daniels (n111) ; Shleifer and Summers, 'Breach of Trust in Hostile Takeovers' in Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (University of Chicago Press 1988).

In terms of the impact on consumers, Romano rejects a market power hypothesis discussed before stating that such an argument is outdated as takeovers with anti-competitive effects are nowadays likely to be challenged or invalidated on competition grounds.[113] Indeed, domestic merger control, which an increasing number of jurisdictions have been adopting over the last two decades,[114] provides for oversight of takeover activities by national competition authorities in the form of e.g., identifying and investigating change of control transactions that give rise to competition concerns and challenging those with a reasonable probability of considerably lessening competition (by either blocking them or limiting their impact on competition by making such transactions subject to conditions).[115] Thus, at least in theory, if a country has an effective[116] system of merger control in place, increased market power does not need to be a major concern in the overall assessment of takeovers' impact.

Nevertheless, according to Aguilera and Jackson, only those with a substantial firm-specific investment such as shareholders, creditors, employees and managers should be considered relevant in the context of takeovers.[117] When studying the effect of hostile takeovers, Schneper and Guillen also focus on creditors and employees due to their engagement in firm-specific investment.[118] Having acknowledged the potential impact of takeovers on different groups of stakeholders, this Chapter will briefly address the interests of employees in a takeover context.

Despite mixed results of the empirical studies on the impact of hostile takeovers on the employees,[119] the available evidence leans towards the expropriation

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[113] Romano (n98) 142-3.

[114] Alexiadis, Sependa and Vlachos, 'Merger Control:'Around the World in 80 Days: Management of the Merger Review Process of Global Deals'' (2018) 19 Business Law International 201.

[115] Thomas, 'The Antitrust Division as a Regulatory Agency: An Enforcement Policy in Transition' in Weidenbaum and Chilton (eds), *Public Policy toward Corporate Takeovers* (Transaction Publishers 1990).

[116] The effectiveness of merger control systems has been a subject of many theoretical discussions and empirical studies, but the results are inconclusive. See eg Duso, Gugler and Yurtoglu, 'How Effective Is European Merger Control?' (2011) 55 European Economic Review 980 ; Aktas, Bodt and Roll, 'Is European M&a Regulation Protectionist?' (2007) 117 The Economic Journal 1096.

[117] Aguilera and Jackson (n112) 450-5.

[118] Guillen and Schneper, 'Stakeholder Rights and Corporate Governance : A Cross-National Study of Hostile Takeovers' (2004) 49 Administrative Science Quarterly 263.

[119] See eg Bhagat and others, 'Hostile Takeovers in the 1980s: The Return to Corporate Specialization' [1990] Brookings Papers on Economic Activity Microeconomics 1, 19-23 (showing that approximately half of hostile takeovers result in cut of target's employment by 5.7%); Conyon and others, 'Do Hostile Mergers Destroy Jobs?' (2001) 45 Journal of Economic Behavior and Organization 427 (concluding that hostile takeovers result in reduction of demand for labour of about 7.5% – such effect is not present in friendly acquisitions); Gugler and Yurtoglu, 'The Effects of Mergers on Company Employment in the USA and Europe' (2004) 22 International Journal of Industrial Organization 481 (noting that only takeovers via tender offer reduce demand for labour); Li, 'Productivity, Restructuring, and the Gains from Takeovers' (2013) 109 Journal of Financial Economics 250 (both employment and wages were marked by substantial decrease, but mostly in case of non-production workers of the target firm); *cf* Brown and Medoff, 'The Impact of Firm Acquisitions on Labor' in Auerbach (ed), *Corporate Takeovers: Causes*

hypothesis and is consistent with a 'breach of trust' theory developed by Shleifer and Summers,[120] further popularised by Stout and Blair[121]. A particular concern has been expressed regarding the value-redistributing rather than value-creating effect of most of hostile takeovers, which assumes that these transactions enable shareholders to benefit at the expense of the employees. Acquisitions equip companies with an opportunity to *ex-post* renegotiate workers' contracts, which involves an expropriation (via a decrease in employment and/or revision of the wage level) from labour to owners of the shares. [122] As pointed out by Williamson, such activities have a dual effect – an immediate, distributional one and a long-lasting, contractual effect, as employees' confidence in the contracting process decreases.[123] Not only actual takeovers but also the prospect of a takeover can alter the terms of the relationship among the company and its employees.[124] It may result in a refusal to tailor their human assets to the specific firm and/or a decline in corporate loyalty which constitutes an increase in a firm's transaction costs because workers require costly, explicit contracts (e.g. including labour protection provisions) or higher compensation for accepting uncertainty about future payments.[125]

Holmstrom admits that transfer of wealth between shareholders and stakeholders is a valid point and it should be accounted for in the evaluation of hostile takeovers' desirability; however, the transfer, he argues, can flow both ways and employees may also benefit[126] from the acquisition by capturing some of the efficiency gains.[127] Yet, available empirical evidence on the effects of takeovers on labour does not only not seem to support this claim, reporting mainly a transfer of wealth from the employees to shareholders. Pontiff, Shleifer and Weisbach found that pension funds were reverted by 15% of the acquiring firms in hostile takeovers and only 8.4% of the acquirers in friendly ones. These reversions accounted on average for approximately 11% of the takeover

and Consequences (University of Chicago Press 1988) (finding that although takeovers were linked with wage reductions of 4%, the employment in the involved firms actually increased by 2%); McGuckin and Nguyen, 'The Impact of Ownership Changes: A View from Labor Markets' (2001) 19 International Journal of Industrial Organization 739 (concluding that takeovers are not the main device for reduction in employment and wages, but they might be associated with increase in employment in the manufacturing industry.

[120] Shleifer and Summers (n112).
[121] Blair and Stout (n112) 305.
[122] Shleifer and Summers (n112) 14.
[123] Williamson, 'Breach of Trust in Hostile Takeovers: Comment' in Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (University of Chicago Press 1988) 62.
[124] Shleifer and Summers (n112) 19-21.
[125] ibid
[126] For example, in the form of wages rise due to the better performance of the company.
[127] Holmstrom, 'Breach of Trust in Hostile Takeovers: Comment' in Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (University of Chicago Press 1988) 56.

premium.[128] Research by Bhagat, Shleifer and Vishny shows that layoffs explain approximately 10 to 20% of the average takeover premium.[129] Although Rosett's study discovers that labour wealth' redistribution accounts for at most 12% of the target shareholders' premiums, it claims that these results do not explain takeover premiums.[130] The major drawback of these empirical studies is the lack of comparable data regarding the number of employees that would have been laid off and what the wage profiles would have looked like if the company had not been acquired (an inefficiently managed company could even have entered into insolvent liquidation).[131] In light of the above arguments and mixed empirical evidence, whether or not the interests of the employees should be given special consideration in the event of a hostile takeover, along with the proposed regulations, will likely depend on the concept of the nature and purpose of the firm that one holds.

The traditional model of the public corporation sees share ownership as no different than ownership of any other type of private property. Under this model, a company is a 'thing' that can be owned and the investors that hold the stock of the company are its owners.[132] Black's Law Dictionary defines property as: '[the] ownership; the unrestricted and exclusive right to a thing; the right to dispose of a thing in every legal way'.[133] The property right view of the firm assumes that its purpose is defined by the owners' property rights. In line with the neoclassical theory of economics that investors are utility maximisers, and that the main part of the utility function of the investors is wealth maximisation (shareholders' wealth is measured by the share prices), the responsibility of executive directors is to run the firm in order to maximise its share price.

Currently widely recognised contractarian theory claims that a firm is a nexus of written and unwritten contracts between the owners of labour, material and capital inputs and the consumers of outputs.[134] Since a company is considered to be a set of contracts, it cannot be owned by shareholders, but it does not imply that they should not have other significant property rights attached to the

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[128] Pontiff, Shleifer and Weisbach, 'Reversions of Excess Pension Assets after Takeovers' (1990) 21 RAND Journal of Economics 600.
[129] Bhagat and others (n119) 2.
[130] Rosett, 'Do Union Wealth Concessions Explain Takeover Premiums? The Evidence on Contract Wages' [1989] NBER Working Paper No w3187.
[131] Romano (n98) 142.
[132] Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm : A Reply to Professor Green' (1993) 50 Washington and Lee Law Review 1423.
[133] Black, Nolan and Connolly, *Black's Law Dictionary. Definitions of Terms and Phrases of American and English Jurisprudence, Ancient and Modern* (West Group 1968) 1382.
[134] Jensen and Meckling (n48).

ownership of common voting stock.[135] According to contractarian theory, groups such as employees are protected by the terms of the contracts they negotiate with the firm.[136] As residual claimants, equity investors are the last to receive payment so they are entitled to what is left from the income stream after all contractual obligations of a firm towards employees, creditors and others have been met. Wages and payments to creditors are fixed contractually, regardless of the level of the firm's financial profit, but the shareholders' residual claim is directly linked to the company's performance. Since shareholders bear most of the risk of a failure of the business, they are therefore entitled to receive most of the rewards of its success, the most important of which is the gain coming from the appreciation of their investments in terms of increased share prices that they own. The contracts of most of the non-shareholder stakeholders include a provision that in exchange for the specified payoff they agree that the resources supplied by them can be used to satisfy the interests of residual claimants[137] and can be sold by the firms without permission of the other contracting constituencies.[138] Thus, the property rights to the divisible residual claims on corporate assets and cash flows can be exercised through the sale of shares to the third parties.[139]

In terms of regulatory approaches to M&As, both theories accept that in the takeover context the shareholders thereby should be free to decide whether or not to accept a tender offer and sell their shares at a given takeover premium without any frustration of the deal from the board of directors. Whether or not investors consider the effect of their action on other stakeholders is in their discretion. Alternatively, in jurisdictions that adopt a 'board discretion rule', the interests of shareholders are protected by ensuring that the fiduciary duties of directors owed to either the company (and indirectly to shareholders) or shareholders are placed ahead of interests of non-shareholder constituencies. The board should pursue the welfare of shareholders, and the only criteria of directors' decision should be an impact on shareholders' wealth (the takeover premium and the probability of completion of the transaction), not the protection of the other stakeholders' interests because those are already protected by the contractual agreements and regulatory solutions. Since the board of directors is faced with a significant conflict of interests in the context of hostile takeovers, having an interest in saving their jobs and reputation instead of maximising the

[135] Deakin and Slinger, 'Hostile Takeovers, Corporate Law, and the Theory of the Firm' (1997) 24 Journal of Law and Society 124.
[136] Fama and Jensen (n47).
[137] ibid
[138] Jensen and Meckling (n48) 305.
[139] Deakin and Slinger (n135).

value of the firm for shareholders, a natural conclusion is that a market for corporate control should be protected by prohibiting the board from engaging in activities that may frustrate takeover attempts.[140] Directors should thus not be granted a discretion to pursue goals that do not cater to the interests of shareholders.

An alternative 'entity view' theory, treats the firm as an entity autonomous from any stakeholder group (including shareholders) with a separate legal status created by the act of incorporation. Such entity cannot be owned - instead of owners, there are various providers of resources who are involved in different types of transactions with the entity. The value of the firm-entity does not depend on wealth of resources passively owned, 'but on the managed system dealing with the flow of relationships involved: that is, on dynamics and process. Stop the dynamics and its value as an entity disappears.'[141] According to Blair, creation of a separate juridical person is an important device for protecting firm-specific investments made by all actors of the firm.[142] The entity view suggests that the ultimate goal of a company is survival,[143] which can be achieved through the maximization of its long-term value, even if the gains are not captured by the current shareholders.[144] Takeovers, particularly hostile ones, are therefore seen as activities that threaten organisational identity and integrity. Shareholders should thus not be the only group of stakeholders considered during or involved in the decision-making process, whether directly or indirectly by the board, regarding the change of control transaction.

One perhaps has noticed inconsistency in the empirical evidence presented above both in relation to their effect on firm's performance, shareholders[145] and some non-shareholder stakeholders. The likely reason for that is the lack of differentiation between different types of takeovers when measuring the post-acquisition performance, since the value creation of a specific takeover to a certain extent depends on its type. Morck, Shleifer and Vishny suggest that it is the friendly takeovers that typically generate synergies, whereas hostile

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[140] High Level Group of Company Law Experts, 'Report on a Modern Regulatory Framework for Company Law in Europe' (04 November 2002) <www.ecgi.org/publications/documents/report_en.pdf> accessed 18 December 2014.

[141] Biondi, 'Accounting and the Economic Nature of the Firm as an Entity' in Dietrich (ed), *Economics of the Firm: Analysis, Evolution and History* (Routledge 2007) 75.

[142] Blair, 'Firm-Specific Human Capital and Theories of the Firm' in Blair and Roe (eds), *Employees and Corporate Governance* (Brookings Institution Press 1999).

[143] Davis and Stout, 'Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Target, 1980-1990' (1992) 37 Administrative Science Quarterly 605.

[144] Guillen and Schneper (n118).

[145] See pages 12-13.

takeovers are usually the disciplining ones.[146] Easterbrook and Fischel argue that hostile takeovers are rather unlikely to realise synergies as those gains are usually accomplished through negotiated acquisitions.[147] Yet, according to Bebchuk, both types of takeovers can produce synergy gains because any motive behind a friendly takeover may lead a prospective acquirer to make a tender offer in case the incumbent board of the target insists on conditions which are unacceptable for the acquirer.[148] Goergen, Martynova and Renneboog conclude that hostile takeovers, in comparison to friendly ones, tend to be more disruptive and are often unable to create long-term synergy effects.[149] Maher and Andersson, on the other hand, claim that takeovers in general rarely increase firms' post-acquisition performance, but the results of hostile takeovers are slightly more positive than those of friendly ones.[150] Ghosh distinguished between two types of takeovers based on the method of payment, suggesting that the transactions conducted to realise synergetic gains are usually financed with shares, while hostile ones are financed with cash.[151] The equity takeovers typically fail to realise the expected synergy gains, while disciplining takeovers result in the increased operating cash flow due to the improved performance generated by correction of the non-value maximising strategies of the target board and better management of the combined firms' assets.[152] Finally, a Switzer's study reports that both hostile and friendly takeovers improved firms' operating performance.[153] Even though the empirical evidence is mixed, the potential differences in the effects of friendly and hostile takeovers are worth noting as this may affect policy considerations.

1.6. Conclusions

The nature and effect of active market for corporate control and the accompanying threat of takeover have long been discussed by academics, practitioners and even the general public. The list of alleged benefits are long: they constitute external and 'self-effectuating' control mechanism which, at least partially, resolve principal-agent problems resulting in better financial performance of listed companies; they facilitate optimal allocation of resources and provide an easy way for shareholders to 'exit' the company, often with a

[146] Morck, Shleifer and Vishny, 'Characteristics of Targets of Hostile and Friendly Takeovers' in Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (University of Chicago Press 1988).
[147] Easterbrook and Fischel (n57) 1169.
[148] Bebchuk (n96) 1028.
[149] Goergen, Martynova and Luc (n20) 6-7.
[150] Maher and Andersson (n68).
[151] Ghosh (n67) 176.
[152] The results were not statistically significant.
[153] Switzer, 'Evidence on Real Gains in Corporate Acquisitions' 48 Journal of Economics and Business 443, 457.

premium paid over the shares' market price. Best of all, to fulfil their monitoring function, hostile takeovers do not even need to materialise – the threat thereof is enough to discipline executive directors.

Takeover sceptics point to their cost, disruptiveness, and alleged effect of managerial short-termism and reduction in investment. Many argue that the market for corporate control does not only not reduce agency costs and that, on the contrary, takeovers are a manifestation of agency problems.

In terms of empirical evidence, there is broad consensus that takeovers result in large share premiums for shareholders of target firms, whilst the returns for acquirers' shareholders are often close to zero or even negative. Whether unrestrained market for corporate benefits the economy as a whole is inconclusive. An increasing number of studies raise concerns regarding the impact of hostile takeover activities on constituencies other than shareholders, arguing that share premiums enjoyed by shareholders often come at expense of non-shareholder stakeholders such as employees.

To sum up, no single theory can definitively encapsulate the nature and effects of hostile takeovers, and the various empirical studies do not lead to firm conclusions. They are nevertheless useful in indicating particular areas on which to focus when analysing regulatory approaches to regulation of hostile takeovers of selected jurisdictions and when providing reform recommendations to China.

CHAPTER II Takeover Regulations in the United States

2.1. Regulatory and Institutional Framework

Takeover activities in the US are governed by a dual regulatory regime that consists of federal securities law and state company law[154]. The federal law governing takeovers mainly consists of the Securities Exchange Act of 1934 (1934 Act). This Act is concerned with procedural rather than substantive matters of takeover regulation, whereas the board's conduct in a takeover context has been left to the individual states, especially to the state courts, to regulate.[155] Since the vast majority of US listed firms[156] are incorporated in Delaware and Delaware courts have addressed the highest number of cases concerning defensive tactics compared to any other state court in the US,[157] this thesis will focus on Delaware state law in the analysis of hostile takeover regulation in the US.

Delaware corporate law comprises the Delaware General Corporation Law (DGCL or Delaware Code) and judicial decisions. Since much of the DGCL creates statutory rules that are not mandatory, firms' constitutional documents, in the form of the certificate of incorporation (charter)[158] and bylaws[159] constitute an important source of rules governing Delaware companies. The regulatory agency responsible for administrating and supervising federal securities law is the Securities and Exchange Commission (SEC), while company law is enforced by the state courts.

2.2. Historical Background

Since there was no comprehensive regulation of takeovers in the US until the late 1960s, one of the most common approaches employed by hostile acquirers was a so-called 'Saturday Night Special',[160] i.e., a strategically abusive tender offer presented to the target shareholders as a short-term, high-price deal available on a first-come first-served basis. The aim was to pressure target shareholders into acting quickly upon the offer by accepting it, rather than risk being left with an illiquid minority holding, likely to be subject to a future

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[154] Referred to as 'corporate law' in the US.
[155] Armour, Jacobs and Milhaupt, 'A Comparative Analysis of Hostile Takeover Regimes in the Us, Uk and Japan (with Implications for Emerging Markets)' (2010) 52 Harvard International Law Journal 262.
[156] Approximately one million business entities are incorporated in Delaware including more than 50% of all US publicly-traded companies as well as more than 50% of the Fortune 500 companies. Black Jr., *Why Corporations Choose Delaware* (Delaware Department of State Division of Corporations 2007) 1.
[157] Freer and Moll, *Principles of Business Organizations* (Thomson Reuters 2013) 375.
[158] DGCL, s102.
[159] DGCL, ss109 and 240.
[160] The term is believed to originate from a Garlock - Colt takeover in 1975. See Davidoff Solomon, 'The Sec and the Failure of Federal, Takeover Regulation' (2007) 34 Florida State University Law Review 211, 216

'squeeze out' at a less attractive price.[161] Congress responded to these abuses in 1968 by enacting the Williams Act, amending the 1934 Act, which addressed specific legal deficiencies in the then legal framework by providing basic procedural rules designed to protect shareholders from the pressure to make rushed and ill-considered decisions.[162]

Post-1968 developments changed not only the way transactions were conducted but also significantly altered the approach of the regulatory and legislative bodies to such transactions. Hostile takeovers from the last phase of the 'third takeover wave' (early 1970s) in the form of coercive going-private transactions[163] and the 'fourth takeover wave' (1984-1989) in the form of acquisitions driven by the presence of conglomerates and cash-rich companies and the emergence of high-yield bonds ('junk bonds') as a method of financing large acquisitions[164] created a new set of challenges for the courts reviewing the conduct of target boards in the hostile takeover context. While deciding on specific cases, policy considerations required the courts to consider whether takeover activities should generally be facilitated, who should be given the ultimate right to decide on takeover offers, the appropriate level of discretion of the target's board in managing the company's affairs when faced with a hostile acquisition, and whether the context in which the offer was made should matter. These considerations led the courts to develop standards of conduct which varied depending on the takeover context.

The standards of conduct for target board of directors in Delaware have been primarily defined by a series of precedents of Delaware courts, which will be analysed in the next sections. Since takeover defences were regulated mainly at the state level, the issue became subject to regulatory competition among the individual states to attract incorporations.[165] In the late 1960s, the state legislatures began to develop antitakeover statutes that would strengthen the ability of a target company and its insiders to fend off unwanted acquisitions.[166] Most states went as far as constitutionally[167] possible in restricting hostile

[161] Armour, Jacobs and Milhaupt, 'The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets : An Analytical Framework' (2011) 52 Harvard International Law Journal 219, 241.
[162] Johnson and Millon, 'Misreading the Williams Act' 87 Michigan Law Review 1862, 1895.
[163] Davidoff Solomon (n160) 219-21.
[164] Kamar, 'The Story of Paramount Communications V. Qvc Network: Everything Is Personal' USC Legal Studies Research Paper No 08-28 2.
[165] See pages 197 - 198 for a more detailed discussion on state competition for corporate charters.
[166] Ventoruzzo, 'Europe 's Thirteenth Directive and U.S. Takeover Regulation: Regulatory Means and Political Economic Ends' (2006) 41 Texas International Law Journal 171, 184-191.
[167] The Supreme Court has interpreted the 'dormant' commerce clause of the Constitution (which empowers Congress 'to regulate Commerce among the several States') to limit power of the states to regulate or impede interstate commerce. See Sidak and Woodward, 'Corporate Takeovers, the Commerce Clause, and the Efficient Anonymity of Shareholders' (1990) 84 Northwestern University Law Review 1093.

takeover activities. Although federal pre-emption of state antitakeover laws reminded a possibility, there was not enough interest group pressure or significant populist political payoff to trigger federal intervention[168] and, as a result, regulation of hostile takeovers has been left to the individual states.

2.3. Basic Principles of Delaware Corporate Law Relevant to Defensive Responses to Hostile Takeovers

By providing that 'the business and affairs of every corporation … shall be managed by or under the direction of a board of directors'[169] the Delaware Code, not the shareholders themselves, initially constitutes the source of directors' power to manage the company.[170] The authority of the board is thus original and undelegated.[171] Individual companies can, however, adopt different rules in relation to distribution of power in their charter because many of the statutory rules are default in nature. The board's power to govern corporate activity is qualified by the shareholders' control rights and directors' fiduciary[172] duties of care and loyalty.

The limited number of matters over which the shareholders have statutory control rights include the election and removal of directors,[173] ratifying transactions involving conflict of interests[174] and decisions concerning actions that are 'fundamental' in nature, such as approval of certain change of control transactions,[175] sale of all or substantially all assets,[176] amendments to the company's charter[177] and bylaws[178] or changing company's state of incorporation[179]. It, therefore, appears that the shareholders can only express their view on matters involving either the 'end of the game' decisions, which bring to an end the existence of the company, or decisions on 'rules of the game', concerning the corporate governance rules by which corporate actors play.[180]

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[168] Kahan and Rock 'Symbiotic Federalism and the Structure of Corporate Law' (2005) 58(5) Vanderbilt Law Review 1573, 1583-1590.
[169] DGCL, s141(a).
[170] Kershaw, *Company Law in Context : Text and Materials* (Oxford University Press 2012) 213.
[171] Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119 Harvard Law Review 1735.
[172] The term 'fiduciary duty' in the US includes both 'duty of loyalty' and 'duty of care', whereas in the UK the primary directors' duties are 'fiduciary duty' and 'duty of care'. See Cahn and Donald, *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the Uk and the USA* (Cambridge University Press 2018) 403.
[173] DGCL, s211(b).
[174] DGCL, s144(a)(2).
[175] DGCL, s251(c).
[176] DGCL, s271.
[177] DGCL, s242.
[178] DGCL, s109(a).
[179] DGCL, s242.
[180] Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 Harvard Law Review 833, 836-7.

Only the board of directors is empowered by the DGCL to call for a shareholder meeting outside of the annual general meeting (AGM), but individual companies can also equip shareholders with such right in their constitutional documents.[181] The company may also decide whether to impose any requirements concerning, e.g., the size and/or time of shareholding which qualifies to call a special meeting.[182] In practice, companies only rarely grant shareholders the right to call for a meeting, and often explicitly exclude such possibility.[183]

Although shareholders entitled to vote have the right to amend the company's constitutional documents, the board of directors has exclusive authority to formulate and propose amendments to the company's charter, which can be approved or rejected by shareholders.[184] This effectively means that, without the support of the board, shareholders cannot implement any changes to the charter. A more empowering procedure applies to the amendment of the company's bylaws, one of the very few actions under Delaware Code that the shareholders have a right to initiate. Nevertheless, a company in its charter may also provide the board with the right to propose and vote on bylaws amendments.[185] In practice, almost all Delaware companies include in their charters an express provision authorising directors to amend the company's bylaws.[186]

Changes introduced by the SEC, following the scandals of Enron and WorldCom that dominated the law reform agenda in the US,[187] now allow shareholders to seek inclusion of their proposal in the company's proxy statement. Proposal rights under Rule 14a-8[188] are subject to certain eligibility criteria and procedural requirements. In order to be eligible to file a proposal to be voted on at the general meeting the shareholder (or a group of shareholders acting together) must either hold 1% of the company's voting shares for a period of one year or at least USD2,000 worth of shares,[189] which generally constitutes a very low ownership threshold. Whilst the company can reject such proposal, it has a burden to demonstrate[190] that the proposal falls within one of the specified substantive grounds for exclusion, such as being in conflict with the company's

[181] DGCL, s211(d).
[182] ibid
[183] Kershaw, *Company Law* (n170) 228-9.
[184] DGCL, s242(b).
[185] DGCL, s109(a).
[186] Choi and Min, 'Amending Corporate Charter and Bylaws' [2017] Faculty Scholarship at Penn Law No 1898 4.
[187] Roe, 'The Corporate Shareholder's Vote and Its Political Economy, in Delaware and in Washington' (2011) 2 Harvard Business Law Review 1, 10.
[188] 17 CFR, s240.14a-8.
[189] 17 CFR, s240.14a-8(b).
[190] 17 CFR, s240.14a-8(j).

proposal or concerning a matter of the company's ordinary business[191] as generally no shareholders' micromanagement is allowed.

Unlike voting for board-initiated proposals, resolutions on shareholder-initiated proposals remain advisory in nature. They are not binding on the board on the ground that it would interfere with its ability to manage the company, even if the shareholders' proposal received the support of the majority of shareholders.[192] It is, therefore, believed that the right to propose bylaws amendments essentially represents the only statutory mechanism through which shareholders' opinion can have a meaningful effect on the company's governance.[193] Thus, activist investors have shifted their focus in recent years to proposals for bylaws amendments rather than relying on proposals to be voted at the AGM,[194] which are basically mere recommendations.

2.3.1. Election and Removal of Directors

Due to the system of plurality voting employed in the election of directors,[195] candidates who receive the largest number of favourable votes are elected to the board. Dissenting shareholders' votes are irrelevant. Consequently, if the election is uncontested by the insurgent shareholder, even one vote in favour would be sufficient for the candidate to be elected.[196] Companies may choose to adopt the majority voting system where an affirmative vote of the majority of shareholders present at the AGM is necessary for director's election.[197] As a result of shareholder activism,[198] more companies have adopted this system, since it increases the ability of shareholders to defeat incumbent directors even in the absence of rival candidates willing to conduct a proxy contest.[199]

The New York Stock Exchange (NYSE) requires candidates to the board to be selected by a nominating/corporate governance committee composed entirely of independent directors,[200] whereas the NASDAQ Stock Market (NASDAQ) provides for the selection of the candidates by either a nomination committee

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[191] 17 CFR, s240.14a-8(i).
[192] Bebchuk, 'The Case...' (n180) 846.
[193] Gill, Liekefett and Wood, 'Structural Defenses to Shareholder Activism' (2014) 47 The Review of Securities and Commodities Regulation 151, 158 ; Bruner, 'Shareholder Bylaws and the Delaware Corporation.' The Tennessee Journal of Business Law, Washington and Lee Legal Studies Paper No 2010-4 67, 68.
[194] Norwitz and others, 'Market Trends: Shareholder Proposals' (2018) The Lexis Practice Advisor Journal <www.lexisnexis.com/lexis-practice-advisor/the-journal/b/lpa/archive/2018/02/28/market-trends-shareholder-proposals.aspx> accessed 10 April 2019.
[195] DGCL, s216(3).
[196] SEC, 'Spotlight on Proxy Matters – the Mechanics of Voting' (23 May 2012) <www.sec.gov/spotlight/proxymatters/voting_mechanics.shtml> accessed 10 June 2016.
[197] DGCL, s.216.
[198] ISS, '2016 Board Practices Study' <> accessed 17 October 2016.
[199] Choper, Coffee and Gilson, *Cases and Materials on Corporations* (Aspen Publishers 2008).
[200] NYSE Listed Company Manual, 303A.04(a)-(b)(i) (NYSE Manual).

comprised solely of independent directors or the majority of the board's independent directors.[201] SEC's adoption of the Rule 14a-11 in 2010 allowed, for the first time, qualified shareholders[202] to include their own candidates in the company's proxy solicitation materials. The proxy access rule, however, was reversed in 2011 by the US Court of Appeals for the District of Columbia Circuit, which considered the rule to be 'arbitrary and capricious'[203]. In response, in 2011, the SEC amended the existing Rule 14a-8 to prohibit companies excluding shareholder proposals that seek board nominations from the proxy materials.[204] As a result, the proxy access is currently available to the qualified shareholders on a case-by-case basis, rather than as of right under Rule 14a-11. Moreover, the Delaware Code allows shareholders to propose candidates to the board if this right is consistent with the company's bylaws.[205] The company may provide for a minimum size/holding period for a shareholder to be eligible to propose the candidate.[206] Inclusion of the shareholder's candidate in proxy materials mailed by the company's shareholders makes it considerably easier and cheaper for shareholders to have their director elected to the board.[207]

Shareholders may also be able to remove directors. Pursuant to Section 141(k) of the DGCL, the office of both an individual director or an entire board can be terminated with or without cause by a majority decision of shareholders entitled to vote. To remove a director outside of the AGM, shareholders would have to call for a special meeting, but, as already discussed, no such right is typically provided by the company's constitutional documents. Shareholders of a company with a staggered board may encounter further difficulties in removing directors since the DGCL provides that directors of firms with staggered boards can only be removed for cause.[208]

By including relevant provisions in their corporate charter, Delaware's companies may adopt the system of cumulative voting for directors' election.[209] If such voting is implemented, only an entire board rather than individual directors can be removed without cause.[210] This protects directors elected through cumulative voting by minority shareholders. The absence of such

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[201] NASDAQ Stock Market Rules, IM-5605-6(e) (NASDAQ Rules).
[202] A shareholder holding at least 3% of the company's shares for a period of at least three years.
[203] *Business Roundtable v SEC,* 647 F.3d 1144 (DC Cir. 2011) 1156.
[204] Ni, 'Proxy Access Revisited: Regulatory Function of the Rule 14a-11 Formula' CLS Blue Sky Blog (30 October 2015) <clsbluesky.law.columbia.edu/2015/10/30/proxy-access-revisited-regulatory-function-of-the-rule-14a-11-formula/> accessed 12 March 2019.
[205] DGCL, s112.
[206] DGCL, s112(1).
[207] Roe (n184)13.
[208] DGCL, s141(k)(1).
[209] DGCL, s214.
[210] DGCL, s141(k)(2).

provision would provide for a mechanism depriving the minority of its voice on the composition of the board as without it, it would be relatively easy for the majority to remove any minority-elected director.[211] Although permissible, cumulative voting is not popular among US companies with only approximately 5% of S&P 500 companies providing for it in their charters.[212] Previously required by many US states, cumulative voting is now mandatory only in six states (it is voluntary in Delaware).[213] Since cumulative voting lowers the vote threshold needed to elect a candidate to the company's board, its use increases the chance of an insurgent shareholder to successfully launch a proxy fight to gain a board seat, and, ultimately, to gain control of the company. This regulatory shift can be, therefore, explained by directors' lobbying activities at the time of the rise of shareholder activism that aimed to convince state legislatures to abolish mandatory cumulative voting in order to protect local companies from unwanted acquirers.[214]

2.3.2. Selected Corporate Governance Mechanisms

Although there is a growing trend of having separate individuals serving the roles of a CEO and a board's chairman,[215] the practice of combining these two positions in the same hands remains relatively common, with approximately 40% of the listed companies having a CEO performing the role of a chairman.[216] In order to counterbalance the combined power of the chair CEO, many companies installed the position of a 'lead' director[217] whose duties involve, among others, collaborating with the chairman in setting agendas for the board meetings, chairing independent directors sessions and evaluating the CEO.[218] The vast majority of S&P 1500 companies which do not have a separate chair and CEO positions, established independent leadership in the form of a lead independent director.[219]

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[211] Editors, 'Cumulative Voting: Removal, Reduction and Classification of Corporate Boards' (1955) 22 The University of Chicago Law Review 751.
[212] Coates, 'Explaining Variation in Takeover Defenses: Blame the Lawyers' (2001) 89 California Law Review 1301; Larcker and Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (Pearson Education 2015).
[213] Coyle, 'Altering Rules, Cumulative Voting, and Venture Capital' (*CLS Blue Sky Blog*, 7 March 2016) <http://clsbluesky.law.columbia.edu/2016/03/07/altering-rules-cumulative-voting-and-venture-capital/"> accessed 15 July 2016.
[214] Gordon, 'Institutions as Relational Investors: A New Look at Cumulative Voting' (1994) 94 Columbia Law Review 124, 145.
[215] A decline from about 57% of companies in 2009. See 'ISS 2018 Board Study' (n198).
[216] 'ISS 2018 Board Study' (n198).
[217] Kershaw, *Company Law* (n170) 270-1.
[218] Stein, 'The Relationship Between the Lead Director and the CEO' (*HLS Forum on Corporate Governance and Financial Regulation,* 21 May 2011) < corpgov.law.harvard.edu/2011/05/21/the-relationship-between-the-lead-director-and-the-ceo/> accessed 10 June 2016.
[219] 'ISS 2018 Board Study' (n198).

Despite no requirement of independent directorship by the DGCL, presence of such directors on the board is strongly encouraged by Delaware case law.[220] At the same time, the listing rules of NYSE[221] and NASDAQ[222] require the majority of a board to be composed of independent directors. The Sarbanes-Oxley Act and Dodd-Frank Act further mandate that listed companies' audit and compensation committees must comprise entirely of independent directors.[223]

NYSE and NASDAQ adopt a bright-line approach when judging the independence of directors. A director may be considered independent under NYSE Listing Rules if the company's board of directors 'affirmatively determine' that the director has no material relationship with the listed company.[224] In addition, no director can be considered independent if e.g., she or he was employed in the company for a period longer than three years,[225] if any of the director's immediate family member has been an executive director within the last three years,[226] if the director received more than USD120,000 (other than in director and committee fees and pension) from the company during any 12 months period within the last three years,[227] or if the director or immediate family member is a partner of a firm which acts as a company's auditor.[228] Independence requirements under NASDAQ Listing Rules are similar.[229]

2.3.3. General Duties of Directors

The board's expansive power to manage the company is qualified by directors' duties of care and loyalty. Compliance with the duty of care requires a director to exercise 'that amount of care which ordinarily careful and prudent men would use in similar circumstances'[230]. A more significant duty from the perspective of a hostile takeover is the duty of loyalty, which requires a director to

> not only affirmatively protect the interests of the corporation committed to their charge, but also refrain from doing anything that would work

[220] For example, an interested transaction approved by a majority of independent directors could result in a deferential standard of review if the transaction is subsequently challenged by the shareholders. Moreover, in case of the companies with the majority of independent board, the shareholders must first make a demand on the board before filing a derivative action.
[221] NYSE Manual, 303A.01.
[222] NASDAQ Rules, IM-5605(b)(1).
[223] Armour and others, 'The Basic Governance Structure: The Interests of Shareholders as a Class' in Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press 2017) 63.
[224] NYSE Manual, 303A.02(a)(i).
[225] NYSE Manual, 303A.02(b)(i).
[226] ibid
[227] NYSE Manual, 303A.02(b)(ii).
[228] NYSE Manual, 303A.02(b)(ii)(A).
[229] NASDAQ Rules, IM-5605(a)(2).
[230] *Graham v Allis-Chalmers Mfg. Co.,* 188 A.2d 125 (Del. 1963) 130.

> injury to the corporation, or to deprive it of profit or advantage which their skill and ability might properly bring to it.[231]

Directors' duties are owed to the company and its shareholders. It appears that the interests of shareholders as a whole are generally not considered to be separate from the interests of the company.[232] Thus, Delaware courts embraced a shareholder-oriented view of the firm.[233] Consequently, fiduciary duties of directors require them to pursue the best interests of the company's shareholders, since the fundamental purpose of the corporate form is to maximise shareholders' wealth.[234] Although directors are permitted to consider the interests of other stakeholders, they are allowed to do so only to the extent of this being congruent with the shareholders' interests.

The business judgement rule (BJR) is 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'.[235] It constitutes a default standard of review in Delaware. As Strine explains, under traditional fiduciary principles a decision made by an informed and disinterested board to pursue a business strategy which does not involve any matter requiring a shareholders' vote is protected by the BJR. In cases where the traditional BJR applies, directors' decisions are protected unless a plaintiff is able to demonstrate that directors have in fact acted with gross negligence[236] or disloyally.[237] If the BJR's presumption is rebutted, the burden shifts to the defendant directors to demonstrate the 'entire fairness' of the transaction.[238] This is a two-pronged test which includes fair price and fair process/dealing.[239] Cases involving the duty of care are usually shielded by the BJR rule, whereas the duty of loyalty cases are often decided by conducting an entire fairness review, which

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[231] *Guth v Loft, Inc.,* 5 A.2d 503 (Del. 1939) 510.
[232] *Cede & Co. v Technicolor, Inc* 634A.2d 345 (Del. 1993) 361('the best interest of the corporation and its shareholders take … precedence … ').
[233] Strine Jr, 'The Professorial Bear Hug: The Esb Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic" Just Say No" Question' (2002) 55 Stanford Law Review 863, 871-2.
[234] ibid 872.
[235] *Aronson v Lewis*, 473 A.2d 805 (Del. 1984) 812.
[236] See eg ibid 812 (' … our analysis satisfies us that under the business judgement rule director liability is predicated upon concepts of gross negligence'); *Smith v Van Gorkom* 488 A.2d 858 (Del. 1985) 873 ('the concept of gross negligence is also the proper standard for determining whether a business judgement reached by a board of directors was an informed one.'); Allen, Jacobs and Strine Jr, 'Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law' (2000) 56 The Business Lawyer 1287, 1300 (gross negligence 'involves a devil-may-care attitude or indifference to duty amounting to recklessness').
[237] *Aronson* (n235) 812 ('Absent an abuse of discretion, that judgement will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption').
[238] Strine Jr (n233) 868.
[239] 'Fair price' relates to the economic and financial considerations of the transaction. 'Fair dealing' reviews such issues as when the transaction was timed, how it was initiated, structured, negotiated and whether it was approved by the independent and disinterested directors. *Weinberger v UOP, Inc.* 457A.2d 701 (Del. 1983) 711.

constitutes the most demanding standard of review in Delaware requiring a significantly higher level of scrutiny.[240] Between deferential treatment under BJR and a rigorous entire fairness review lies the standard of 'enhanced scrutiny',[241] typically used in reviewing decisions of the board to adopt defensive measures in the context of hostile takeovers.

2.4. Directors' Role in the Takeover Context

Since the boards of Delaware companies control almost every aspect of corporate activity, they also retain relative freedom in the area of the M&A transactions in which they generally do not have an obligation to agree or even start negotiating the process of selling the company. The court in *Unitrin, Inc. v Am. Gen. Corp.*[242] noted that 'when a corporation is not for sale, the board of directors is the defender of the metaphorical medieval corporate bastion and protector of the corporation's shareholders'[243]. There are, however, situations when the directors' role changes from that of 'defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company'[244]. The following sections address the board's role and the scope of its authority to adopt anti-takeover measures in different takeover contexts.

2.4.1. Defensive Responses to Hostile Takeovers

Whether or not directors are allowed to resist a takeover attempt depends on the nature and timing of the transaction as well as the nature and timing of any defensive tactic adopted. *Unocal Corp. v Mesa Petroleum Co*.[245] established a template for a review of defensive measures when a company has not put itself in play. Instead of benefiting from the presumption of the traditional BJR, the board of directors carries the initial burden of proving that its conduct satisfies the 'enhanced scrutiny' standard. The board is required to demonstrate that: firstly, there were reasonable grounds for believing that a threat to corporate policy and/or its effectiveness existed[246] ('threat test' or 'reasonableness test') and secondly, that the defensive measures taken in the light thereof were appropriate in relation to the threat posed[247] ('proportionality test').

[240] Pinto and Branson, *Understanding Corporate Law* (LexisNexis 2013) 399.
[241] See Part 2.4.1 for further explanation.
[242] 651A.2d 1361 (Del. 1995).
[243] ibid 1388.
[244] *Revlon, Inc. v MacAndrews & Forbes Holdings, Inc*., 506 A.2d 173 (Del. 1986) 182.
[245] 493A.2d 946 (Del. 1985).
[246] ibid 955.
[247] ibid 955-6.

To satisfy the 'threat' test of the *Unocal* standard it must be shown that, after reasonable investigation, the board determined in good faith that there was a threat to the company which warranted the use of a defensive tactic.[248] The good faith element is satisfied if directors show that they acted in response to the identified threat, not for the purpose of entrenching their position.[249] Gilson and Krakmaan[250] identified three categories of threats: opportunity loss, where a takeover offer might deprive the shareholders of the opportunity to select a superior alternative offered by the target board; structural coercion, where there is a risk that disparate treatment of shareholders might influence their decisions whether or not to tender; and substantive coercion, where there is a risk that shareholders may mistakenly accept an under-priced but non-coercive bid, because they distrust the board's long-term business plan or its assessment of the firm's intrinsic value. The reasonable investigation element involves a procedural inquiry into the board's examination and requires proving that the directors were adequately informed applying the gross negligence[251] standard of review. The investigation may include such concerns as the price offered, the timing of the offer, questions of illegality, the risk of the proposed transaction not being finalised, and the impact on stakeholders other than shareholders (e.g., employees, creditors, and even the community generally).[252]

The 'proportionality test' of the *Unocal* standard was further developed in *Unitrin,* another landmark Delaware case. When assessing the 'proportionality' of the board's action, the court must first determine whether the directors' response to a takeover offer was 'draconian' by being either coercive, in that it forced upon shareholders a 'management-sponsored alternative' to a hostile bid, [253] or preclusive in that it would render a successful acquisition 'mathematically impossible' or 'realistically unattainable'.[254] If the board's reaction was neither coercive nor preclusive, then the court must consider whether the decision was within the 'range of reasonableness' under the circumstances then existing,[255] a standard established in *QVC v Paramount*[256]. In analysing a target board decision to defend against the takeover, the court will assess whether the decision made was 'reasonable', not 'perfect'.[257]

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[248] *Unitrin* (n242) 1392.
[249] Bainbridge, *Corporate Law* (Foundation Press 2015) 391.
[250] Gilson and Kraakman, 'Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review' (1988) 44 The Business Lawyer 247.
[251] See n236.
[252] *Unocal* (n245) 955.
[253] *Unitrin* (n242) 1387.
[254] ibid 1389.
[255] ibid 1388.
[256] 637A.2d 34, 45-6.
[257] *Unitrin* (n242) 1385.

If the board satisfies both tests, then the BJR applies and the court will not second guess its decision,[258] otherwise defensive tactics are subject to the entire fairness review.[259] Anti-takeover measures will be invalid unless the board can demonstrate that they were 'entirely fair' to the shareholders.[260] Even under the stringent entire fairness standard, the board may shift the burden of proof back to the plaintiff by utilising procedural safeguards, the most important of which is the establishment of a special committee of disinterested and independent directors.[261]

It must, however, be noted that once the so-called 'break-up' of the company is inevitable, the target board of directors cannot resist the hostile bid and the board's role becomes that of 'auctioneers'. This is known as the *Revlon* duty, from the seminal case of *Revlon, Inc. v MacAndrews Forbes Holdings, Inc.*[262] The 'break-up' of the company is considered inevitable in circumstances where the board either initiates an active bidding process to sell the company to an acquirer or effects a reorganisation resulting in its clear break-up, reacts to a takeover attempt by abandoning its long-term strategy and seeking another transaction that involves the break-up of the firm, or approves a transaction that results in a sale or change of control.[263]

Although the court in *Revlon* described obtaining the best price as the directors' ultimate duty, it has since been confirmed that the board must 'secure the highest value reasonably attainable for the stockholders'[264]. This indicates that when evaluating the offers, directors must not look solely at the price offered by the bidders, but should also consider other terms of the offers and the likelihood of deals' consummation. The process of securing the best deal involves two components: first, obtaining sufficient information so the board can appropriately evaluate the firm's value, and second, structuring the sale process so that the price received by shareholders approximates or exceeds that value.[265] The board is not allowed to favour one bidder over another based on e.g., possible synergies for the company post-acquisition, it must treat all potential acquirers on an equal basis focusing solely on the return for shareholders. If there are two or more capable bidders presenting offers comparable in terms of timing

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[258] ibid 1385.
[259] Choper, Coffee and Gilson (n196) 976.
[260] See page 34 for explanation.
[261] Chalian and Bandura 'The Business Judgement Rule and the Entire Fairness Doctrine' <http://www.rc.com/documents/Primer%20on%20Business%20Judgment%20Rule.pdf> accessed 17 May 2016.
[262] Revlon (n244).
[263] *Arnold v Society for Sav. Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994) 1289-90.
[264] *McMillan v Intercargo Corp.* 768A.2d 492 (Del. Ch. 2000) 502.
[265] Choper, Coffee and Gilson (n196).

and likelihood of consummation, then the board must look solely at the price.[266] While comparing two or more cash offers the target board cannot choose the lower one because it has advantages for stakeholders, such as employees and customers. Being in *Revlon* mode does not mean that directors are not allowed to use any particular defensive tactics – they cannot resist the takeover but there is no one single method, a blueprint, that the board must follow to fulfil its *Revlon* duties.[267] This means that the board is given considerable autonomy in determining if and which tactics to use to secure the best value for the company's shareholders.

The court may apply even more stringent scrutiny when the board tries to change certain 'rules of the corporate game' in reaction to a threat of a specific takeover. If the target adopts defensive measures in the middle of the takeover battle and appears to have done so for the 'primary purpose' of interfering with the shareholders votes or, more generally, impeding the exercise of shareholders' franchise the board may face review under the *Blasius* test, adopted by the Chancery Court in yet another seminal case, *Blasius Industries, Inc. v Atlas Corp.*[268] Chancellor Allen established in *Blasius* that when directors act for the primary purpose of thwarting the exercise of the shareholders' right to vote they bear the responsibility of demonstrating a 'compelling justification' for their actions.[269] Despite the heavy burden placed on directors, there is no rule invalidating measures adopted to frustrate shareholder franchise.[270]

To constitute a 'compelling justification', the action must be motivated by a legitimate objective, be reasonable in relation to this objective and not preclusive or coercive,[271] yet it is not entirely clear how exactly such defence could be established, as the standard set in *Blasius* has been applied in a limited number of cases because of the court's hesitance to invoke it.[272] It is often believed that the *Blasius* test virtually determines the outcome: once triggered by the board's defensive action it appears impossible to present to the court a sufficiently compelling justification so as to pass the test.[273] However, in *Mercier, et al. v Inter-Tel*,[274] the then Vice-Chancellor Strine suggested that the *Blasius* test was

[266] Wachtell and others, 'Takeover Law and Practice' [2012] Wachtell, Lipton, Rosen & Katz.
[267] *Barkan v Amsted Industries, Inc.,* 567A.2d 1279 (Del. 1989) 1287.
[268] 564A.2d 651 (Del. Ch. 1988) 662.
[269] ibid 662.
[270] ibid 661-2.
[271] Strine Jr, 'The Story of Blasius Industries V. Atlas Corp.: Keeping the Electoral Path to Takeovers Clear' in Ramseyer (ed), *Corporate Law Stories* (Foundation Press 2009).
[272] Siegel, 'The Problems and Promise of 'Enhanced Business Judgement' (2015) 17 University of Pennsylvania Journal of Business Law 47, 52.
[273] ibid
[274] 929A.2d 786 (Del. Ch. 2007)

'an after-the-fact label placed on a result' rather than a meaningful standard of review and as such it should be reformulated.[275] The court displayed a willingness to be flexible when scrutinising actions taken in connection with shareholders voting outside of directorial elections, such as adjournments and postponements of the general meeting, at least when the actions are taken in good faith, without improper motivation and in the best interests of the shareholders.[276] The court in *Mercier* thus opted to apply *Blasius* as a reasonableness standard consistent with the *Unocal* analysis, stating that the *Blasius* approach should be reserved primarily for 'director election contests or election contests having consequences for corporate control.'[277] The board would have to first demonstrate a compelling justification for interfering with or impeding the exercise of shareholders' franchise in a contested election context as a condition precedent to any judicial consideration of *Unocal*'s reasonableness and proportionality.

2.4.1.1. Pre-bid Defences

There are plenty of measures available to US companies to deter potential hostile acquirers. A general perception from the takeover cases reviewed under Delaware law is that the courts have more tolerance for reasonable anti-takeover protections if they are adopted on a 'clear day' i.e. before the start of a contest for control.[278] Such defences employed with an appropriate business rationale typically benefit from the protection of the BJR.

2.4.1.1.1. Entrenchment Provisions

The Delaware Code explicitly allows the adoption of a staggered board; the board may be divided into a maximum of three classes of directors who serve staggered terms.[279] Only one class of directors can be removed or elected each year.[280] The prevalence of such boards has decreased significantly in recent years with only approximately 13% of the S&P 500 and approximately 35% of the S&P 1500 companies having staggered boards in 2018.[281]

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[275] ibid 788.
[276] *Mercier* (n274) 808-11.
[277] ibid 809-10.
[278] Wolf, 'Advantages of Board Actions on a " Clear Day"' (*HLS Forum on Corporate Governance and Financial Regulation,* 26 November 2014) <corpgov.law.harvard.edu/2014/11/26/advantages-of-board-actions-on-a-clear-day/> accessed 18 May 2016.
[279] DGCL, s141(d).
[280] ibid
[281] ISS, 'US Board Study. Board Accountability Practices Review' (April 2018) (ISS 2018 Board Study) <www.issgovernance.com/file/publications/board-accountability-practices-review-2018.pdf> accessed 20 January 2019.

Although Section 141(k) of the DGCL provides for removal of directors without cause unless there is a staggered board,[282] it used to be a common practice for US companies to include in their constitutional documents provisions prohibiting such removal. However, the 2015 ruling of the Chancery Court in *Re Vaalco Energy Sholders Litig.*[283] (*Vaalco*) invalidated such provisions, making it unlawful for companies which do not have a staggered board or cumulative voting to restrict shareholders' ability to remove directors without cause. The court's decision is particularly relevant to large listed companies since, as discussed above, the vast majority of these companies have abandoned staggered boards. Shareholders of companies with staggered boards, in particular those of the medium size companies (approximately half of which still have such boards[284]) may find it difficult to remove a director because such companies, although allowed to amend the rule in Section 141(k) by inserting appropriate provision to the company's charter,[285] very rarely do so in practice.[286]

Moreover, in 2017 the Chancery Court held in *Frechter v Zier*[287] that provisions of constitutional documents requiring a vote greater than a simple majority to remove directors violate Section 141(k) of the DGCL, which 'unambiguously confers on a majority the power to remove directors.'[288]

2.4.1.1.2. Golden Parachutes

Golden parachutes have been broadly adopted by the majority of US listed companies during the third and fourth merger waves in order to provide protection to executive directors designed to align their incentives with those of shareholders in the case of unsolicited bids.[289]

In 1984, sections 280G and 4999 applying a basic framework regulating golden parachutes[290] were added to the Internal Revenue Code (IRC).[291] Section 280G prohibits corporate tax deductions for 'excess' parachute payments and section 4999 imposes a 20% excise tax on 'excess' parachute payments, which together create adverse tax consequences for both the company which pay the

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[282] See page 31.
[283] CA No 11775-VCL (Del. Ch. 2015).
[284] 'ISS 2018 Board Study' (n278) (47% of S&P 600).
[285] DGCL, 141(k)(1).
[286] Bebchuk, Cohen and Ferrell, 'What Matters in Corporate Governance?' (2008) 22 The Review of financial studies 783.
[287] CA No 12038-VCG (Del. Ch. 2017).
[288] ibid 8.
[289] Fiss, 'A Short History of Golden Parachutes' *Harvard Business Review* (03 October 2016) < hbr.org/2016/10/a-short-history-of-golden-parachutes> accessed 20 November 2016.
[290] ibid
[291] Choi, Lund and Schonlau, 'Golden Parachutes and the Limits of Shareholder Voting' Virginia Law and Economics Research Paper No 2018-13, 10.

compensation and a director receiving it. 'Excess' payment is a payment exceeding an amount equal to three times the average taxable compensation over the five most recent years preceding the change in control transaction (the base amount).[292] It is, however, often believed that instead of curbing excessive golden parachutes, the law has effectively legitimated compensations up to the threshold provided, making payments of 2.99 times the base amount the new norm.[293]

Further regulation of both executive remuneration in general and golden parachutes specifically reflects an attempt to strengthen the shareholder voice in this area. From 2011, shareholders of public companies enjoy the so-called 'Say on Pay' (SOP) and 'Say on Golden Parachute' (SOGP) rights provided under the Dodd-Frank Act.[294] While SOP requires companies to conduct a shareholders' advisory vote on the previous year's executive remuneration practices, SOGP provides shareholders with the right to approve or disapprove on an advisory basis a specific severance payment payable to executive directors in the context of a change of control transaction.[295] The effectiveness of these provisions is debatable. Fich, Tran and Walking found that approximately 86% of listed companies have golden parachutes in place. The highest value reported equalled 5.25 times the executive's base amount.[296] A recent study by Choi, Lund and Schonlau suggests that the SOGP voting regime is ineffective in controlling the level of compensation in the event of a takeover, as in the years following the passage of Dodd-Frank Act the size of golden parachutes appears to have increased.[297]

2.4.1.1.3. Shareholders Right Plan (US-style Poison Pill)

Devised by the corporate lawyer Martin Lipton, the shareholder rights plan was created to protect firms from corporate raiders by offering the board of directors both the chance to level the playing field and time to respond to hostile bids.[298] At first, the poison pill spurred controversy because of its potential illegality due to e.g., a board's want of authority to issue shares for a purpose other than to

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[292] 26 USC s280G(b)(2)(ii) and s280G(d)(2).
[293] Fiss (n289).
[294] 'SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act' (25 January 2011) <https://www.sec.gov/news/press/2011/2011-25.htm> accessed 13 May 2016.
[295] ibid
[296] Fich, Tran and Walkling, 'On the Importance of Golden Parachutes' (2013) 48 Journal of Financial and Quantitative Analysis 1717, 1725.
[297] Choi, Lund and Schonlau (n288) 32-9.
[298] Ovide, 'Marty Lipton: Why I Invented the Poison Pill' *The Wall Street Journal* (29 December 2010) <https://blogs.wsj.com/deals/2010/12/29/marty-lipton-why-i-invented-the-poison-pill/> accessed 15 May 2016.

raise capital and the pill's discriminatory treatment of one or more shareholders. However, in 1985 the Supreme Court in *Moran v Household International Inc*.[299] upheld the pill, confirming that there is no statutory limitation on its use. It acknowledged the validity of the board's power to issue shares not principally to raise capital, but to construct a financial disincentive to accumulate the company's shares. At the same time, the court also initially indicated that the right to use the pill is not absolute and that the board may be required to redeem the pill.[300]

Even though rights issues in general are unobjectionable, the use of the poison pill is nevertheless often litigated based on allegations of breach of fiduciary duty,[301] especially in relation to the pill's triggering point as well as its method of redemption. A shareholder rights plan adopted on a 'clear day' purely as a pre-bid measure is typically protected under the BJR,[302] however, if it was adopted in response to a specific bid, or a bidder appears on the horizon asking for the pill to be redeemed, it may no longer enjoy the shield of a pure pre-bid defence and the courts are likely to apply the higher *Unocal* level of scrutiny when reviewing its adoption.

An acceptable threshold of share ownership, beyond which the poison pill is triggered creating an effective barrier to share accumulation is typically around 10 – 15%, although based on the court's decision in *Versata Enterprises Inc. v Selectica, Inc.*[303] *(Selectica)*, which approved a triggering point as low as 5%, it may appear that *any* ownership threshold to trigger the poison pill is allowed in Delaware. The target directors in *Selectica* implemented the pill with a very low triggering point to fend off acquirers in order to protect the company's Net Operating Loss (NOL).[304] Making use of an existing NOL is beneficial for the company as it allows it to reduce its tax obligations. Section 382 of the IRC restricts the use of NOL following a change in ownership, which means that a substantial portion of the company's value may be lost in case of a takeover.[305] For this reason, the court in *Selectica* decided that the pill used did not violate the *Unocal* standard because the prospective loss of the NOL constituted a threat to the company. Although the pill made it difficult for a potential bidder to acquire control, it was not considered to be preclusive because an acquisition

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[299] 500A.2d.1346.(Del.1985).
[300] ibid 1354.
[301] Pinto and Branson (n240) 399.
[302] ibid
[303] CA No 193, 2010 (Del. Oct. 4, 2010).
[304] Similar to the UK's 'trading loss'. NOLs are tax losses accumulated by a company, that can be used to shelter future or immediate past income from taxation by deducting against the company's income in those years.
[305] *Selectica* (n303) 6.

was not 'realistically unattainable'.[306] However, the fact that adoption of a low-triggered pill is acceptable under certain circumstances should not be treated as a general approval of a very low triggering threshold in a rights plan applicable to all firms in Delaware.[307] Similarly, the presence of NOL neither automatically grants the firm the right to adopt the pill with low triggering point nor allows the firm to keep the pill in place for as long as the target board wishes.

In terms of the pill's method of redemption, two particular types of rights plan attracted a great deal of opposition from the courts – those with a 'dead hand' provision of unlimited duration where only the directors who adopted the pill can redeem it and those with a 'no hand' provision which prohibits a board from redeeming the pill for a certain period of time. The issue of deferred redemption provisions was considered in Delaware in 1998 in *Carmody v Toll Bros*[308] (resulting in the invalidation of a 'dead hand pill') and *Quickturn Design Systems, Inc. v Shapiro*[309] (resulting in the invalidation of a 'no hand pill'). The Supreme Court held that such provisions are invalid under Section 141(a) of the DGCL, which confers upon the board full power to manage the company, and pills with deferred redemption provisions deprive the newly elected board of its statutory authority and prevent it from wholly discharging its management duties.[310]

Another controversial aspect of the pill's redemption relates to its longevity, involving questions of how long the pill can remain in place and whether it has to be redeemed at all by the existing board. Delaware courts' attempt to address this issue has been rather unsuccessful. The decision in *City Capital Associates v Interco Inc.*[311] (*Interco*) seemed to suggest that the target board is not permitted to use the poison pill indefinitely, and that once the pill fulfils its designated role it should be redeemed by the board allowing shareholders to decide whether or not to sell their shares. In Chancellor Allen's view, the pill adopted by *Interco* had served its purpose and thus had no further legitimate role.[312] The Chancery Court ordered redemption of the pill in *Interco* and a few other cases,[313] suggesting a limitation on the authority of the board to keep the pill.[314] Yet, the Supreme Court in *Paramount Communications, Inc. v Time, Inc.*[315] (*Time-*

[306] ibid 41-2.
[307] ibid 49.
[308] CA No 15983, Jacobs, VC, 1998 WL 418896 (Del.Ch. July 24, 1998).
[309] 721A.2d 1281 (Del. 1998).
[310] ibid 1291-2.
[311] 551A.2d 787 (Del. Ch. 1988).
[312] ibid 790-1, 800.
[313] Eg *Grand Metropolitan Public Ltd. Co. v Pillsbury Co.* 558 A.2d 1049 (Del. Ch. 1988).
[314] Strine Jr, 'The Professorial Bear Hug' (n233) 873.
[315] 571A.2d 1140 (Del.1989).

Warner) expressly disapproved '*Interco* and its progeny'.[316] In *Unitrin*, the Supreme Court held that a rights plan which is not preclusive generally need not be redeemed as long as the bidder has a realistic prospect of winning a proxy fight to replace the target board.[317]

Whilst the shareholder rights plan was first introduced in the US in order to fend off unsuitable and coercive acquisitions, nowadays it is often justified by the threat of losing the company's NOL. However, only a handful of companies face a real threat related to NOL's impairment.[318] Moreover, the GDCL permits the companies to adopt a provision in their constitutional documents restricting transfer and ownership of shares for the purpose of maintaining or preserving any tax attribute, including the NOL,[319] which may be used to deter transactions motivated by the company's NOL. Thus, it seems plausible that the real reason behind the adoption of the pill presently, especially the low-triggered one, is simply a deterrence of activist shareholders, which aim to pressure the company's directors, as argued by Hurt[320] and Kahan and Rock[321].

In light of this argument, a shift in the attitude of institutional investors towards the poison pill observed in recent years is not surprising. As a result of the increased aversion and shareholders campaigning against the rights plan, the number of companies with a 'clear day' pill in place has significantly declined.[322] In the event of an unsolicited acquisition, the majority of listed companies[323] can nevertheless reasonably quickly adopt a rights plan because their constitutional documents allow the board to issue enough pre-authorised shares to promptly create an effective poison pill.[324] In 2010 the Chancery Court in *Yucaipa American Alliance Fund II, L.P. v Riggio*[325] (*Yucaipa*) accepted an argument that the possibility of relinquishing control by the company's shareholder through a creeping acquisition without the benefit of receiving a

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[316] ibid 1153 (discussion on the poison pill was dicta, as Time, the defendant, had not relied on the pill to defend against a hostile takeover).
[317] *Unitrin* (n242) 1390-1.
[318] Hurt, 'The Hostile Poison Pill' (2016) 50 UC Davis Law Review 137, 184-187.
[319] DGCL, s202(d)(1)b.
[320] Hurt (n315) 181.
[321] Kahan and Rock, 'Anti-Activist Poison Pills' NYU Law and Economics Research Paper No 17-08.
[322] See eg Laide, 'Rethinking the Role of the Poison Pill?' (*sharkrepellent.net*, 17 Sept 2008) <https://www.sharkrepellent.net/pub/rs_20080916.html> accessed 01 April 2019 (noting a decline in adoption of poison pill from 85% in 2001 to 32% in 2004); Catan, 'The Insignificance of Clear-Day Poison Pills' [2016] NYU Law and Economics Research Paper No 16-33; Journal of Legal Studies, Available at SSRN: 2836223 (noting a decline among large listed companies in adoption of poison pill from 60% in 2002 to less than 10% in 2014).
[323] In 2013 95% of the S&P 500 firms had blank check preferred stock. See Gill, Liekefett and Wood (n190).
[324] A study by Subramanian showed that despite this possibility, 59% of S&P 1500 companies without the pill decided not to resort to adopting the rights plan even when a hostile bidder emerged. Subramanian, 'Delaware's Choice: A Brief Reply to Commentators' (2014) 39 Delaware Journal of Corporate Law 85.
[325] CA No 5465-VCS (Del. Ch. Aug. 12, 2010).

control premium constituted a valid threat to which poison pill was a reasonable response. It, therefore, appears that almost an unrestricted use of the shareholder rights plan is alive and well in Delaware. This is compounded by the requirement to file with the SEC 'Schedule 13D' or 'Schedule 13G',[326] which effectively places the market on alert for creeping acquisitions and significantly limits the disciplining role of hostile takeovers.

2.4.1.2. Post-bid Defences

2.4.1.2.1. Just Say No Defence

Court decisions in relation to the adoption and redemption of shareholder rights plans have sparked discussion on whether or not, under Delaware law, a disinterested and well-informed board can resist any takeover offer, even one that is all-cash and fully funded.

In *Interco,* Chancellor Allen held that if a sole threat of a tender offer is price inadequacy, a target board is permitted to use takeover defences, but only for a limited period of time. In the court's view, in case of a threat of substantive coercion, a defensive measure can be deployed in order to secure time to either persuade target shareholders not to accept the bid or to find a better alternative for them. Once this is done, the defensive measure must be removed so that shareholders can decide whether or not to sell their shares.[327] In *Interco* the court argued that the value of the tender offer and the board's business proposal were relatively similar thus the threat of price inadequacy was small, making the use of the poison pill unjustifiable in the longer term.[328] By holding that corporate law should respect both shareholders and directors within their own domains of choice and authority, *Interco* lean towards the shareholders choice model, opposing a 'just say no' defence.[329] During the then ongoing battle between the acquirer, Oracle Corporation, and PeopleSoft's target board, it remained possible that Vice Chancellor Strine would order PeopleSoft to redeem its poison pill,[330] but the case was settled before a decision was issued.[331] However, in light of subsequent decisions of Delaware courts, *Interco's* validity and applicability,

[326] See page 50 for further discussion.
[327] *Interco* (n311) 798.
[328] ibid 798-9.
[329] Strine Jr, 'The Professional Bear Hug…' (n233).
[330] Subramanian, 'Bargaining In...'(n34) 19-21; Davidoff Solomon, *Gods at War: Shotgun Takeovers, Government by Deal, and the Private Equity Implosion* (John Wiley & Sons 2009) 206.
[331] Farrel, 'As Suits End, Judge Says Deal Was Only Way to Resolve Fight' *NY Times* (14 December 2004) <www.nytimes.com/2004/12/14/technology> accessed 13 July 2016.

as pointed out by Davidoff Solomon,[332] is limited at best. Many[333] suggest that the current state of Delaware law permits the board to 'just say no' to any offer on the grounds of, for example, the offer being inadequately priced or the firm being not for sale, which effectively stops shareholders from selling their shares at directors' discretion. Indeed, the Supreme Court's explicit rejection of '*Interco* and its progeny' in *Time-Warner*[334] and its open criticism of the lower court's application of *Unocal* standard was driven by the fact that the Chancery Court substituted the board's evaluation of the adequacy of the takeover offer with its own judgement, which, in the Supreme Court's view, was an erroneous application of the *Unocal* test. The Court then granted the target board permission to defend against a non-coercive acquisition offer on the basis that directors have no obligation 'to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy'.[335]

This rather unfortunate decision, [336] unsurprisingly, was treated as a legitimisation of the just say no defence.[337] Yet, according to Bainbridge,[338] *Time-Warner* should not be treated as an ultimate validation of *just saying no* (in response to an adequate, non-coercive offer) due to the unique facts of the case – the Time's board decision to use defensive measures was not aimed to delay the hostile bid to 'cram down' on its shareholders a management-sponsored alternative but was intended to continue execution of a sound, pre-existing business plan. The Chancery Court in the later case of *Airgas v Air Products*,[339] upheld the use of a poison pill to fend off a hostile bidder, considering that the company had a long-term plan endorsed by the board and the board was not obliged to respond to an acquisition offer.[340]

The just say no defence seems to be closely connected to the concept of substantive coercion. Firstly, it is not entirely clear when substantive coercion can be perceived by a target board as a threat justifying defensive measures. In

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[332] Davidoff Solomon, *Gods at War: Shotgun Takeovers, Government by Deal, and the Private Equity Implosion (n327) 206*.
[333] Eg Gordon, 'Just Say Never? Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett' (1997) 19 Cardozo Law Review 511, 525 Lipton, 'Pills, Polls, and Professors Redux' (2002) 69 The University of Chicago Law Review 1037
[334] *Time-Warner* (n315) 1153.
[335] ibid 1152.
[336] For criticism of the Supreme Court's decision see: Gilson, 'Unocal Fifteen Year Later (and What We Can Do About It)' (2001) 26 Delaware Journal of Corporate Law 491, 498-52.
[337] Eg ibid 498-52.; Gordon, 'Just Say Never? Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett', 525; Velasco, 'The Enduring Illegitimacy of the Poison Pill' (2001) 27 Journal of Corporation Law 381, 418.
[338] Bainbridge, *Corporate Law (*n246) 399-40*0*.
[339] 16A.3d 48 (Del. Ch. 2011).
[340] ibid 55.

Unitrin, the Supreme Court confirmed the validity of substantive coercion as a threat and reinforced the concept that an inadequately valued offer may constitute a 'legally cognisable threat' that justifies the adoption of takeover defences.[341] Although in *Airgas* Chancellor Chandler acknowledged that he had 'a hard time believing that inadequate price alone in the context of a non-discriminatory, all-cash, all-shares, fully financed offer poses any threat … at this point in time',[342] the precedent compelled him to allow the board to keep the rights plan in place. The Court nevertheless expressly indicated that this does not mean that the board can *just say no* at all times on the grounds of offer inadequacy.[343] The board can *say no*, i.e., decide when, and if, the company is for sale, if it acts in good faith and is able to pass the rigorous judicial fact-finding embedded in the standard of enhanced scrutiny by showing that after a reasonable investigation (preferably with reliance upon advice of outside advisors) it determined that the offer is inadequate and as such poses a legitimate threat. At the same time, the court will not accept the inadequacy of the price under the stricter standard of *Blasius* as a justification for *saying no* to directors' elections during the takeover contest.[344]

The controversy surrounding the doctrine of substantive coercion is closely connected with the debate regarding the applicable standards of review of takeover transactions. Gilson and Krakmaan[345] expressed concern that the inclusion of substantive coercion among the threats which allow the board to adopt defensive tactics may result in the 'proportionality' test, instead of being meaningful, being effectively downgraded into a BJR. The Chancery Court itself noted in *Chesapeake Corp. v Shore*,[346] that giving the board permission to use a defence of substantive coercion without 'a serious examination of the legitimacy of that defence' would weaken the purpose the *Unocal* standard of review was established to serve.[347] Ritter[348] argues that by permitting the target board to adopt anti-takeover mechanisms if the offer is considered by the board to be inadequate, *Unocal* nowadays allows directors to substitute the shareholders' judgment of the bid's adequacy with their own: it deprives shareholders of the basic freedom to dispose of their shares as they wish. According to Gilson and Kraakman, the shareholders' willingness to sell their shares suggests that the risk

[341] *Unitrin* (n242) 1384.
[342] *Airgas* (n339) 56.
[343] ibid 54.
[344] *Mercier* (n274) 805-06.
[345] Gilson and Kraakman (n250) 260.
[346] 771A.2d 293 (Del. Ch. 2000).
[347] ibid 329.
[348] Ritter, 'Unocal Corp. V. Mesa Petroleum Co' (1986) 72 Virginia Law Review 851.

of the board's misrepresentation is more likely than the correctness of the claim the board is making about the firm's higher intrinsic value.[349] Defensive measures taken on the basis of substantive coercion may thus be seen as gambles made on behalf of target shareholders by possibly self-interested directors. Even if the board is correct regarding the price inadequacy, shareholders would nevertheless be better off if the gamble at their expense was not made.[350] A court, they argue, is in no better position than shareholders and the market to evaluate the board's claim about the firm's value. There is, therefore, no ground for a court to override the assessment of the market by permitting defensive measures as a response to an offer with a premium above the market price.[351] On the other hand, it is equally arguable that not accepting price inadequacy as a valid motive for employing defences amounts to a substitution of the court's own business judgment for that of the board.

When commenting on *Blasius*, Strine attempted to clarify the issue of just say no defence explaining that Chancellor Allen in *Blasius* established a firewall which would ensure that no matter how extensive the authority of the board is to impede an offer during its office, it is not allowed to *just say no* to the shareholders' right to elect directors,[352] allowing shareholders to overcome the board's defensive strategy by launching a proxy contest.[353] Thus, despite a wide discretion to exercise their business judgment to obstruct a takeover attempt even if the shareholders disagree, the board has no authority to prevent them from deciding that a new board should be elected to manage the company. Hence, it appears that under Delaware law directors are permitted to *just say no*, however they are not allowed to *just say never*.[354] Indeed, the 'proxy out' concept was one of the basis of approval of a shareholders rights plan in *Moran*, which assumed that an election process could provide an ultimate escape from the pill.[355] The Chancery Court in *Mercier* clearly distinguished between the boards' conduct in relation to governing the firm and its behaviour in relation to the process by which the board is elected, providing that the concept of substantive coercion should not be accepted to justify actions taken in regard to director elections,[356] as the shareholders should be able to elect new members to the board who may then decide on an offer in line with shareholders' will. Although

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[349] Gilson and Kraakman (n250) 263.
[350] ibid 274.
[351] ibid 263.
[352] *Mercier* (n274) 811.
[353] Strine Jr, 'The Story of Blasius' (n271).
[354] *Airgas* (n339) 129.
[355] Strine Jr, 'The Professorial Bear Hug' (n233) 876.
[356] *Mercier* (n274) 818.

not immediate, there should be a viable alternative for shareholders to influence a takeover outcome through the election process. However, under the existing Delaware law, even if directors lose an election over an outstanding offer, they are in practice allowed to further block the bid by combining a rights plan with an 'effective staggered board'[357] (ESB).[358] Such a combination, as noted by Bebchuk, Coates IV and Subramanian, makes the overall defensive measure preclusive.[359] The Chancery Court in *Yucaipa* considered this to be a plausible argument.[360] It held that the combination could be considered preclusive when a bidder who makes a general, structurally non-coercive offer has:

> (1) won a proxy contest for a third of the seats of a classified board; (2) is not able to proceed with its tender offer for another year because the incumbent board majority will not redeem the rights as to the offer; and (3) is required to take all the various economic risks that would come with maintaining the bid for another year.[361]

It was, however, decided that the case before the court was different from the hypothetical case discussed.[362] Gordon argues that situations where an incumbent board retains the pill despite the bidder's winning of one proxy contest are in reality very rare.[363] The exact situation nonetheless occurred in *Airgas,* which seriously calls into question the Delaware court's assurance that the board has no right to *just say never*.

2.5. General Provisions Regulating Takeover Bids[364]

The objective of the Williams Act is 'the protection of investors who are confronted with a tender offer'.[365] Such protection involves creating a framework in which shareholders can make decisions without being pressured into tendering their shares in order to avoid becoming minority shareholders under the new control.[366] The legislative history of the Act also shows that it aimed to strike a balance by providing shareholders with adequate time and

[357] See page 31 for more information on staggered boards in the US.
[358] Bebchuk, Coates IV and Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy' (2002) 54 Stanford Law Review 887, 946.
[359] ibid 946.
[360] *Yucaipa* (n325) 70.
[361] ibid 70.
[362] ibid 71.
[363] Gordon, 'Takeover Defenses Work. Is That Such a Bad Thing?' (2002) 55 Stanford Law Review 819, 834.
[364] There are different sets of rules that apply to a tender offer made by the target company for its own shares and by parties other than the target company. This thesis focuses on the latter.
[365] *Piper v Chris-Craft Industries,* 430 US 35.
[366] Bainbridge, *Corporate Law* (n249) 216.

information to evaluate a tender offer[367] and by allowing the incumbent board an opportunity to fairly present its case to shareholders.[368] It is also clear that Congress did not intend to unduly impede takeovers, as it was recognised that takeover activities can benefit shareholders by holding entrenched executives accountable.[369]

2.5.1. Right to Information

Disclosure requirements constitute a central plank of the federal law regulating takeovers. An investor who, after acquiring publicly traded equity securities, becomes a beneficial owner of more than 5% of the class, is required to make certain filings with the SEC within ten days of the purchase that triggers the reporting threshold.[370] There is no requirement to cease acquisitions during the ten-day reporting period. The investor must file form 'Schedule 13D' disclosing its identity and future plans. Information such as the number of securities purchased, whether the purpose of the purchase is to acquire control of the target, whether there are any plans to liquidate the firm or change its corporate structure (e.g. membership of the board of directors) must also be supplied.[371]

Having recognised that the extensive disclosure obligations constituted unnecessary burden placed on 'passive investors',[372] the SEC made amendments stating that those who do not acquire shares for the purpose of or with the effect of changing or influencing the control of the companies are only required to file form 'Schedule 13G'[373] which demands significantly less information.[374] The passive investor must nonetheless file Schedule 13D once it crosses the 20% threshold of beneficial ownership, or if the nature of the investment has changed.[375] Such an investor is not permitted to exercise its voting rights and cannot purchase more shares during the reporting period.

Extensive disclosure protects target shareholders by supplying them with relevant information and giving them time to make an informed decision.[376] At the same time, it creates a system of 'early warning' which allows directors to

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[367] There is no statutory definition of the term 'tender offer'. Whether an offer or a series of purchases constitutes a tender offer within the meaning of the Williams Act is often determined using the 'eight factor test' cited in *Wellman v Dickinson* 475 F. Supp. 783, (SDNY 1979). See *Wellman*, 823-24 for the mentioned factors.
[368] *Piper* (n325) 72.
[369] ibid 30.
[370] 17 CFR, s240.13d-1(a).
[371] 17 CFR, s240.13d-101.
[372] SEC, Amendments to Beneficial Ownership Reporting Requirements, Release No 34-39538 (12 January 1998) 2.
[373] 17 CFR, s240.13d-1(b)(1)(i).
[374] 17 CFR, s240.13d-102.
[375] 17 CFR, s240.13d-1(e)(1) and 240.13d-1(f)(1).
[376] *Bainbridge, Corporate Law (*n246) 407.

indicate a potential acquirer. One of the most criticised aspects is the 'ten-day window' of the reporting period where there is no requirement to cease share acquisitions.[377] A recent case in which the hedge fund Pershing Square and Valeant Pharmaceuticals together accumulated nearly 5% of Allergen's shares within ten days from crossing the reporting threshold[378] indicates the magnitude of the problem associated with the lack of such a prohibition. Despite being urged to 'close the window' for many years, the SEC has not taken any steps in such direction. The likely reason for the SEC's inaction is the positive effect of the ten-day window on shareholder activism, which is often believed to be beneficial to public companies as it provides a counterweight to 'entrenched' boards of directors.[379]

Apart from the ongoing disclosure requirement, the acquirer who decides to launch a tender offer is required to provide certain types of information to the target shareholders at the time of or shortly after the offer commencement.[380] Shareholders must be supplied with information regarding the bidder, such as its identity, the number of securities sought, an explanation of any material change in shareholders' rights following the transaction[381] as well as the purpose of the transaction and any plans related to e.g. material sale of assets, material change in the present dividend policy, change to corporate structure or amendments to the company's constitutional documents [382].

Moreover, the target board is required to supply shareholders of the target company within ten days of the date of the offer's commencement with its statement on the offer.[383] The board may either recommend accepting or rejecting the offer, express no opinion and take a neutral ground towards the offer or state that it is unable to take a position and explain why.[384] Directors of the target who wish to communicate with shareholders regarding the offer must file with the SEC and deliver to its shareholders a Tender Offer Solicitation/Recommendation Statement – 'Schedule 14D-9',[385] which discloses e.g. whether or not directors have any outstanding securities in the company, any material arrangements with the bidder, whether they intend to tender the shares

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[377] Nagel and others, 'The Williams Act: A Truly "Modern" Assessment' (HLS Forum on Corporate Governance and Financial Regulation, 22 October 2011) <corpgov.law.harvard.edu/2011/10/22/the-williams-act-a-truly-modern-assessment/> accessed 09 April 2016.
[378] *Allergan, Inc. v Valeant Pharm. Int'l, Inc.,* CA No 14-1214 (C.D. Cal. Nov. 4, 2014) 6.
[379] Falk, Jebejian and Schiele, *Hot Topics in Mergers and Acquisitions 2015* (Practising Law Institute, 2015) 425.
[380] 17 CFR, s240.14d-6.
[381] 17 CFR, s229.1004(a)(1).
[382] 17 CFR, s229.1006.
[383] 17 CFR, s240.14e-2(a).
[384] ibid
[385] 17 CFR, s240.14d-9(b)(1).

owned, etc.[386] Schedule 14D-9 aims to assist shareholders of the target in assessing the merits of directors' solicitation/recommendation and in evaluating the interests of directors making the communication.

2.5.2. Right to Equal Treatment

Firstly, the offer must be open to all holders of the class of securities subject to it.[387] Secondly, shareholders are entitled to receive the highest consideration paid to any other shareholder for shares tendered in the offer.[388] When the acquirer increases the offer price, all tendering shareholders of the same class must be paid the same price.[389]

In order to ensure equal treatment, the bidder is prohibited from purchasing shares from shareholders outside of the tender offer.[390] Such prohibition begins upon public announcement of the offer rather than its commencement,[391] that is from the occurrence of any oral or written communication by the bidder that is designed to, or has the effect of, informing the public or shareholders about the offer. Whilst neither a mandatory bid nor launching a full offer is required by federal law, partial offers must proceed on a pro rata basis.[392] Thus, the old tactic of 'Saturday Night Specials' mentioned in Part 2.2 has been eliminated and all shareholders who decide to sell their shares have a chance to receive a premium for at least some part of their equity.

2.5.3. Squeeze-out and Sell-out Rights

Following the tender offer, an acquirer who obtains at least 90% of the target shares of each class is given the right to squeeze-out minority shareholders through implementation of a 'short-term' merger pursuant to Section 253(a) of the GDCL, without the necessity of seeking approval of the shareholders. Even where the 90% threshold has not been reached, the acquirer can easily squeeze-out dissenting target shareholders through a common practice of a back-end merger ('freeze out' merger) which constitutes a combination of a tender offer with a merger under Section 251(h). Introduced to the Delaware Code in 2013, Section 251(h) provides that a shareholder vote is not required to effect the second step of the back-end merger following a tender offer for all shares as long as the bidder has acquired a simple majority of the target's shares.

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[386] ibid
[387] 17 CFR, s240.14d-10(a)(1).
[388] 17 CFR, s240.14d-10(a)(2).
[389] 15 USC, s78n(d)(7).
[390] 17 CFR, s240.14e-5(a).
[391] 17 CFR, s240.14e-5(a).
[392] 15 USC, s78n(d)(6).

In both cases, minority shareholders who have been squeezed out are entitled to statutory appraisal under Section 262(b)(2) of the DGCL through litigation over the appropriateness of the consideration paid where the consideration was anything other than shares of the surviving company or the shares of a public company ('market out' rule).[393] Shareholders who voted against or at least refrained from voting for the merger[394] may request the court to determine the 'fair value' of their shares in order to receive the determined consideration in cash plus interest from the effective date of the merger. The utilisation of appraisal rights has increased significantly in recent years due to the increased practice of appraisal arbitrage by hedge funds.[395] In 2013 approximately 15% of eligible transactions attracted appraisal litigation.[396]

2.5.4. Right to Sufficient Time to Make Decisions

A tender offer must be left open for a minimum of 20 business days from the date it is first presented.[397] There is no maximum offer period. If there is any material change to the terms of the offer, it must remain open for the additional 10 business days from the date the notice is first published.[398]

Shareholders are allowed to withdraw shares tendered in response to the offer at any time during the offer and either up to 60 days after the offer commences or up to seven days after its closure.[399] During this subsequent offering period, shareholders may tender their shares without withdrawal rights.[400]

2.5.5. The Role of Financial Advisors

Whilst the target board is not required to use a financial advisor, a fairness opinion supplied by an advisor is nevertheless a very important tool which may serve as evidence of due diligence on the part of the target board with regards to the takeover transaction and any defences employed. The Chancery Court stated

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[393] DGCL, s262(b)(2)a-b.
[394] DGCL, s262(d)(1).
[395] Korsmo and Myers, 'Appraisal Arbitrage and the Future of Public Company M&A' (2015) 92 Washington University Law Review 1551; Davidoff Solomon, 'Delaware Courts Pause on the Deal Price Do-Over' *New York Times* (19 February 2015) <www.nytimes.com/2015/02/20/business/dealbook/delaware-courts-pause-on-the-deal-price-do-over.html> accessed 17 August 2016.
[396] ibid 1568-9. In order to limit the occurrence of appraisal arbitrage where investors capitalise on the price increase of previously undervalued shares, shareholders seeking appraisal must show that the record holder had not voted in favour of the merger. There are various methods to determine what value shareholders are entitled to receive such as Market Value of Share, Earnings Value and Asset Value, however, the courts nowadays often utilise the original offer price as a reliable indicator of fair value; see eg *Re Appraisal of Ancestry.com Inc*, 2915 WL 66825 (Del.Ch. Jan. 5 2015); *Re Appraisal of Dell, Inc*., CA No 9322-VCL, 2016 WL 3186538 (Del. Ch. May 31, 2016).
[397] 17 CFR, s240.14e-1(a).
[398] 17 CFR, s240.14e-1(b).
[399] 15 USC, s78n(d)(5); 17 CFR, s240.14d-7.
[400] 17 CFR, s240.14-11(e).

in *Re Del Monte Foods Sholders Litig.*[401] that in reviewing the adequacy of the directors' decision–making, the court will consider the extent to which the board had relied on expert advisors.[402] The opinion typically focuses on addressing the fairness of the consideration to be received by target shareholders.[403] The target board can rely on the opinion and valuation of the advisor in deciding whether to recommend or reject the offer in both friendly and hostile takeovers. Such advisors do not advise the target shareholders directly, rather they supply an opinion to the board, which then summarises the opinion in the proxy statement or filings with the SEC.[404]

Since there is no requirement for advisors to be completely independent, it is relatively common that the same investment bank/financial intermediary that structured and priced the offer for the acquirer also provides a fairness opinion to the target board.[405] Siming's study reports that approximately 9.5% of the examined transactions involved an advisor in both buy-side financing and sell-side advising.[406] Such a dual role constitutes a risk that the advice given to the target is driven by a desire to earn fees from financing the successful acquisition. Indeed, in transactions with dual-role advisors, the premium obtained for the target shareholders was approximately 12% lower as compared to transactions without such advisors.[407]

Because of the possible conflict of interests, the work of financial advisor is subject to disclosure requirements dictated by both federal law and Delaware state rules. Firstly, the target board is required to disclose a summary of all material terms of employment and other arrangements for compensation with those advising the board on the transaction.[408] Disclosure should typically include e.g., the types of fees payable, whether the fees are contingent or guaranteed, either quantitative disclosure of the fees, or adequate qualitative disclosure so that shareholders can identify any conflicts of interests or incentives that might motivate the financial advisor; and any other information about the financial terms that would be material to the shareholder's evaluation of the merits of the advisor's analysis and its impartiality in making

[401] 25 A.3d 813 (Del. Ch. 2011).
[402] ibid 831.
[403] Brown and Whittington, 'The Role of the Independent Financial Adviser in M&a Fairness Opinions' [2009] Financial Adviser Insights 64.
[404] ibid 65.
[405] ibid 64.
[406] Siming, 'Dual Role Advisors and Conflicts of Interest' (2011) 8 Corporate Ownership and Control 42.
[407] ibid 43.
[408] 17 CFR, ss240.14d-101 and 229.1009(a).

recommendations.[409] A mere statement that the advisors are entitled to 'customary fees' would typically not fulfil the disclosure requirement[410] as it must always provide sufficient specificity to enable an informed judgement. Further, Delaware courts have also noted the importance of the role of financial advisors, insisting that extensive disclosure of fees and potential conflicts of interest is necessary. In *Re Atheros Communications, Inc v Consolidated Sholders Litig.*[411] (*Atheros*), the court stated that in cases where a substantial portion of the contingency fee to be received by the advisor relies on completion of the transaction, it might be necessary to disclose in detail what the 'substantial portion' exactly means. The court explained that there is no clear point at which the contingency percentage is material, concluding that in cases such as *Atheros*, where 98% of the fee is contingent upon the consummation of the deal, detailed disclosure would be required.[412]

Moreover, apart from the boards' disclosure, Delaware courts in recent years have closely scrutinised the conduct of financial advisors, allowing target shareholders to sue sell-side advisors for monetary damages. The common claim of target shareholders is financial advisor's aiding and abetting a breach of the directors' fiduciary duty. Such liability arises when the advisor knows 'that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum.'[413] Four elements must be proved for a claim to succeed: the existence of a fiduciary relationship; a breach of the fiduciary's duty; knowing participation[414] by a non-fiduciary in the breach, and damages proximately caused by the breach.[415]

In the post-trial opinion in *Re Rural Metro Corp. Sholders Litig.*[416] (*Rural Metro II*) the Chancery Court held the advisor liable for aiding and abetting, awarding the shareholders almost USD76million in damages (83% of the total award).[417] Moreover, in a number of recent cases[418] courts have indicated that it is part of

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[409] SEC, 'Guidance Regarding Tender Offers and Schedules' (18 Nov 2018) (SEC's Tender Offers Guidance) <www.sec.gov/divisions/corpfin/guidance/cdi-tender-offers-and-schedules.htm> accessed 06 January 2019.

[410] ibid

[411] CA No 6124-VCN 2011 (Del. Ch. Mar. 4, 2011) 22-3.

[412] ibid 24.

[413] *In Re Rural Metro Corp.,* 88 A.3d 54 (Del. Ch. 2014) 97 (*Rural Metro I*)

[414] It must be established that the advisor acted with the knowledge that the conduct assisted constitutes a breach. The requirement of participation can be established if the alleged aider and abettor 'participated in the board's decisions, conspired with [the] board, or otherwise caused the board to make the decisions at issue', *Malpiede v Townson,* 780 A.2d 1075 (Del. 2001) 1096-98.

[415] DiCarlo, 'Revving-up Revlon in the Wake of Rural Metro: A Call for Direct Liability on Financial Advisors' (2018) 48 Seton Hall Law Review 871, 886-9.

[416] 102 A.3d 205 (Del. Ch. 2014) (*Rural Metro II*).

[417] ibid 206.

[418] Eg *Del Monte* (n401) 831; *Re El Paso Corp. Sholders Litig.*, 41 A.3d 432 (Del. Ch. 2012) 434; *Rural Metro I* (n417) 90.

the target board's responsibility in the context of takeovers to learn about actual and potential conflicts faced by the advisors through, for example, informing itself about any previous relationship with potential acquirers and considering a number of financial advisors in the process of selecting the most suitable one.

2.6. Conclusions

The US's approach to regulating corporate governance of its public companies is often characterised as directors' primacy. The dominant role of the board is also reflected in the context of takeovers since the US adopts the 'board discretion rule' to govern its conduct when the company is faced with a potential change of control.

Both pre-bid and post-bid defences are generally allowed to be used by the target directors, subject to fiduciary duties and judicial review. The court will typically assess board's use of such measures using business judgment rule when defences are adopted on a 'clear day', i.e. before the start of the contest for corporate control. The legitimacy of anti-takeover mechanisms employed by the board in response to a threat of a specific bid is reviewed using the enhanced standard of scrutiny and determined by the *Unocal, Revlon or Blasius* test, which drew the limitations of incumbent boards' use of takeover defences. Whether or not directors are allowed to resist a change of control transaction depends on its nature and timing. If directors have an established and sound business strategy for the company, they generally can 'say no' to any acquisition as long as adopted defensive tactics are proportionate to the threat posed and are not draconian or preclusive. *Blasius* clarified that the right to use defensive measures is in effect only during the office of the incumbent board – the board is not permitted to 'say never' to shareholders' right to replace the board. Once directors put the company up for sale or its breakup becomes inevitable, their role changes from the company's 'guardians' to the auctioneers, whose only aim is to get the highest price possible for the target shareholders. In order to determine the applicable standard of review, Delaware courts assess each transaction in light of its particular set of facts and circumstances.

Concerns have been expressed that an inclusion of price inadequacy among the accepted threats under the *Unocal* standard downgrades the 'proportionality' test from being meaningful into an embellishment of the business judgement rule. The Delaware Court itself admitted that giving the board permission to use a 'substantive coercion' defence without a serious examination of its legitimacy

undercuts the purpose that the *Unocal* standard of review was established to serve.

Even if directors' defensive action ultimately attracts the entire fairness review, defendants may shift the burden of proof back to the plaintiff by utilising procedural safeguards, among the most prominent of which is the establishment of a special committee of independent and disinterested directors to protect the interests of all shareholders.

Target shareholders are provided with some protection by the 1934 Act and the SEC which regulates procedural aspects of the bids. Yet, the takeover regime at the federal level does not include e.g. the mandatory bid rule. The disclosure-based model relies on the market surveillance and the regulatory system at the state level, hence directors' broad discretion to protect the company and its shareholders against hostile suitors in Delaware.

Chapter III Takeover Regulations in the United Kingdom

3.1. Regulatory and Institutional Framework

The primary sources of law relevant to takeovers of listed companies in the UK are the Companies Act 2006 (CA 2006),[419] which provides the primary statutory framework for the regulation of corporate affairs in the UK, and the City Code on Takeovers and Mergers (Takeover Code),[420] a body of rules governing takeovers of firms listed on regulated markets. Other relevant regulations include the Disclosure and Transparency Rules (DTRs)[421] and the Listing Rules,[422] which firms with premium listing are required to comply with. Moreover, the UK Corporate Governance Code 2018 (CG Code),[423] which follows the 'comply or explain' approach, sets up standards of good practice in relation to the company's governance and board leadership.

As a member of the European Union (EU),[424] the UK was required to harmonise its takeover regulations with those of the EU via implementation of Directive 2004/25/EC (Takeover Directive or Directive).[425] Implementation of the Takeover Directive led to a very few substantive changes to the UK takeover regime[426] because of the possibility of opting out of certain provisions of the Directive if a Member State did not find them appropriate and the fact that many of the core principles and compulsory aspects of the Directive were modelled on the UK's Takeover Code.[427] The main effect of implementation amounted to a shift from self-regulation to statutory regulation of takeovers in the UK. Since the Directive requires Member States to designate a supervisory authority for takeovers,[428] the Panel on Takeovers and Mergers (Takeover Panel or Panel),[429]

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[419] Companies Act 2006 (CA).
[420] The City Code on Takeovers and Mergers (TC).
[421] Disclosure and Transparency Rules (DTRs).
[422] Listing Rules (LR).
[423] Corporate Governance Code 2018 (CGC).
[424] Implications of the UK leaving the EU as a result of the vote on 'Brexit' will not be considered in this thesis.
[425] Directive 2004/25/EC of 21 April 2004 on Takeover Bids (Takeover Directive). The Directive contains minimum EU rules concerning the regulation of takeover activities of firms listed on regulated markets in the Member States (MS) with an objective to 'establish minimum guidelines for the conduct of takeovers bids and ensure an adequate level of protection for holders of securities throughout the Community'. As such, the Directive forms general principles governing acquisitions in the MS without attempting detailed harmonisation. Among the aspects addressed by the Directive are the mandatory bid rule, equitable price, disclosure requirements as well as 'sell-out' and 'squeeze-out' rights. The provisions particularly relevant to the regulation of anti-takeover measures are included in Article 9, which regulates the target board's conduct once the offer has been made; Article 11, which addresses the possibility to 'breakthrough' the obstacles to takeovers adopted prior to the offer; and Article 12, which affords the optional and reciprocal application of the Article 9 and Article 11.
[426] Clerc and others, 'A Legal and Economic Assessment of European Takeover Regulation. Ceps Papers 7525' (2012) Centre for European Policy Studies.
[427] Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 The Cambridge Law Journal 422, 448.
[428] Takeover Directive, art 4(1).
[429] CA, pt 28.

which had been regulating and supervising takeovers without statutory mandate since 1968,[430] took on the statutory role of competent authority that oversees and regulates takeovers in 2006.[431]

The Panel operates through a number of Committees[432] and its core functions include rule-making (writing the Takeover Code and keeping it up to date)[433] and a quasi-judicial function (giving rulings on the interpretation, application or effect of the rules).[434] The first function is assigned to the Code Committee, its responsibility being to keep the Code under review and to propose, consult on and make amendments to the it.[435] The day-to-day work of supervision and regulation of takeovers is assigned to the Executive.[436] Headed by the Director, the Executive consists of employees and secondees from accountancy firms, law firms, investment banks and other organisations.[437] It conducts investigations either on its own initiative or at the request of third parties, monitors relevant transactions in accordance with the Takeover Code and provides rulings on the interpretation, application or effect of the Code. When an individual is in doubt whether a proposed course of action is in accordance with the Takeover Code it must approach the Executive.[438] The Hearings Committee, mainly responsible for reviewing decisions of the Executive, also hears disciplinary proceedings instituted by the Executive if the latter suspects a potential breach of the Code.[439] The Appeal Board is an independent body responsible for hearing appeals against decisions of the Hearing Committee.[440]

3.2. Historical Background

In the UK, the regulation of takeovers developed separately to the regulation of the securities market.[441] Mainly due to the tax regulations that favoured collective investment schemes, institutional shareholders become one of the most influential groups in the City of London's corporate community in the mid-1960s.[442] Apart from lobbying for the preferred rules, institutional shareholders were able to pre-empt public regulation by creating an environment where

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[430] Johnston (n427) 442.
[431] CA, s942.
[432] TC, Introduction 4.
[433] CA.2006, s943.
[434] CA.2006, s946.
[435] TC, Introduction 4(a).
[436] TC, Introduction 5.
[437] ibid
[438] ibid
[439] TC, Appendix 9, 1.
[440] TC, Introduction 8.
[441] Gullifer and Payne, *Corporate Finance Law: Principles and Policy* (Bloomsbury Publishing 2015) 682.
[442] Armour and Skeel Jr, 'Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of Us and Uk Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1768-9.

private rules were successfully enforced. This was possible thanks to the frequent and repeated interactions amongst this community, where compliance pressure and penalisation through reputational sanctions were used to enforce desired rules.[443] When the first wave of hostile takeovers occurred in the UK in 1950s, the Government had close links with the Bank of England, which then was connected to the City institutions. Thus, it is often believed[444] that the viewpoints and interests of the shareholders were heard and catered for by relevant organs. This position was contested by Kershaw, who argues that the fact that the Notes were characterised by a pro-shareholder approach does not necessarily constitute an evidence that shareholders were the group which predominantly influenced regulatory development to protect their own interests.[445] Rather, it was merchant banks represented by trade associations such as Issuing Houses Association and Accepting Houses who took a leading role in drafting takeover regulations.

The great boom of M&A activities in the mid-1950's exposed the need for regulation. A number of leading City institutions and trade associations was gathered by the Bank of England to create the City Working Party responsible for drawing up the first takeover rules in the UK.[446] Concern over use of defensive measures led to the creation of the Notes of Amalgamation of British Businesses (Notes) in 1959, where the precursor to the board neutrality providing that is should be left to the shareholders to decide whether to sell their shares was introduced for the first time.[447] Despite the Notes adopting a shareholder-focused approach, their effectiveness in protecting shareholder interests were limited by the lack of mechanisms for adjudication and enforcement.[448]

In response to the growing number of intensely contested takeovers, the City Working Party was revived to draft more comprehensive regulations, which resulted in the first version of the Takeover Code being issued in 1968.[449] The Takeover Panel, acting as a supervisory organ, quickly gained confidence and authority notwithstanding its lack of statutory authority, mainly because its

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[443] ibid 1772.
[444] ibid 1771-2.
[445] Kershaw, *Principles of Takeover Regulations* (Oxford University Press 2016) 86-101, 105-107 .
[446] Rider, 'Self-Regulation: The British Approach to Policing Conduct in the Securities Business, with Particular Reference to the Role of the City Panel on Take-Overs and Mergers in the Regulation of Insider Trading' (1978) 1 Journal of Comparative Law and Securities Regulation 319.
[447] Kershaw, *Principles of Takeover Regulations* (n445) 84-85.
[448] Armour and Skeel Jr (n442) 1759-71.
[449] Kershaw, *Principles of Takeover Regulations* (n445) 98.

membership primarily constituted respected and powerful figures with a major interest in M&A activities.[450]

This overview of the development of takeover regulations provides two important insights into the existing shape of the UK takeover regime. Firstly, its pro-shareholder approach has been influenced by the identity of the drafters of the Takeover Code. The parties involved were leading City organisations including institutional investors and trade associations representing merchant banks, who had a clear interest in the rules that would facilitate an active market for corporate control. Merchant bankers, in particular, were invested in creating such a market in which they were central actors through their client-serving actions. The historical outline also provides an explanation of the self-regulatory model of the UK's takeover regulation and the substantial level of informality adopted by the Panel. Firstly, the Bank of England and other City institutions all had an interest in preserving their role in drafting and enforcing takeover rules to avoid intervention of the state in the form of a state takeover regulator. This made them to coordinate together to create a more effective takeover regime in which the Panel was able to effectively discipline the market participants despite not having statutory footing and performing its work purely on self-regulatory basis.[451]

Secondly, since the Panel's members originate primarily from the corporate world, rather than the legal community, speed and efficiency has always been an important feature of its work, hence its preference for proactive involvement and addressing issues in real time as they arise rather than through *ex-post* judicial review.

3.3. Basic Principles of Company Law Relevant to Defensive Responses to Hostile Takeovers

In the UK the division of powers between the board of directors and the shareholders is determined by the company's articles of association (AAs), subject to any mandatory provisions of the CA 2006. It is, therefore, the shareholders who grant authority to the board through the articles. In the absence of an article allocating power to the board, it would have no power at all.[452]

Pursuant to the Model Articles for Public Companies[453] (Model Articles), the board of directors is responsible for managing the company' business, for which

[450] Gullifer and Payne (n439) 682; Kershaw, *Principles of Takeover Regulations* (n445) 105-6
[451] Kershaw, *Principles of…* (n445) 96-7.
[452] Kershaw, *Company Law…* (n170) 213.
[453] The Companies (Model Articles) Regulations 2008, Model Articles for Public Companies, sch 3 (MA).

purpose it may exercise all the powers of the company.[454] Where there is no direct conflict of interest for directors in relation to a transaction, the CA 2006 does not typically provide for shareholder approval rights.[455] Certain transactions may require a shareholders' vote under the CA 2006[456] or the Listing Rules.[457] Moreover, fundamental transactions involving 'end-game decisions' (e.g., sanctioning a scheme of arrangement[458]) and transactions involving changing 'the rules of the game' (e.g., amendment of the company's articles[459]) require approval of a special majority of 75%. Whereas in public companies it is normally the board of directors that proposes and formulates the amendments to the company's AAs, there is no requirement of board participation in the process under the CA 2006 or the Model Articles. A shareholder may propose an amendment[460] which is then voted upon by the shareholders at the general meeting.

Although shareholders generally cannot instruct directors by the way of ordinary resolution,[461] shareholder(s) holding at least 5% of the voting rights or a group of 100 shareholders[462] have a statutory right to add a resolution to be voted on at the company's AGM.[463] There is no minimum holding period and no additional costs are borne by the shareholders to circulate their proposal.[464] Distribution of the proposal outside of the AGM must be sponsored by the proposing shareholder.

For pressing matters, shareholders with at least 5% of the company's paid-up capital having voting rights can require directors to call a general meeting.[465] Directors must call the meeting within 21 days from the date of the request and convene it within 28 days after the date of the notice holding the meeting.[466] If the board does not respond properly to shareholder's request, those who

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[454] MA, art 3.
[455] Even where the conflict of interest occurs the board may be authorised by the company's articles to approve such conflicted transaction. See eg, CA, arts 177 and 182; MA, art 16.
[456] CA, pt 10 ch 4.
[457] Significant transitions are divided into two categories based on the gross assets test, the profits test; the consideration test; and the gross capital test (LR 10 Annex 1). Class 2 transactions are transactions where any percentage ratio is 5% or more but each is less than 25% (LR 10.2.2). Class 1 transactions are transactions where any percentage ratio is 25% or over. Whilst Class 2 transactions require disclosure only (LR 10.4.1(1)), Class 1 transactions must be approved by the company's shareholders (10.5.1(2)).
[458] CA, pt26.
[459] CA, s21(1).
[460] As discussed, a qualified shareholder has a right to call a general meeting and propose a shareholders' resolution.
[461] Shareholders wishing to direct the board to take or refrain from taking a specific action can only do so by a way of special resolution. MA, art 4.
[462] Each of whom paid up on average at least £100 and who has a right to vote.
[463] CA, s338.
[464] CA, s340.
[465] CA, s303(2)(a).
[466] CA, s304(1).

requested the meeting can call it themselves at the expense of the company.[467] The board's scope to restrict or delay convening the general meeting is therefore limited, ensuring that shareholders have effective proposal rights which they can exercise in practice.[468]

An empirical study by Buchmanan and others[469] indicates that large institutional shareholders and former directors constitute the most active sponsors of shareholders' proposals. The vast majority of proposals (more than 90%) target either board elections or the company's business strategies.[470] Such requests, however, rarely occur[471] since directors are rather responsive to shareholders' concerns because of their annual re-election.[472]

3.3.1. Election and Removal of Directors

The CG Code provides for annual election of all company's directors.[473] The UK follows the majority voting system[474] where a simple majority of shareholders can vote against – and hence block – election of a specific director. Qualified shareholders can nominate their candidates to the board through a proposal to be circulated at the general meeting.[475] Other candidates are selected by the nomination committee consisting mainly of independent non-executive directors (NEDs).[476] In identifying suitable candidates for the chair and NEDs, the nomination committee should use advertising and/or the services of external consultants[477] and consider candidates based on merit and against identified objective criteria.[478]

The nomination committee has discretion in selecting suitable candidates, but recent developments in corporate governance provide for higher scrutiny of its work. The board is now required to consult the shareholders when the resolution attracts the opposition of 20% or more of shareholders votes.[479] According to the Public Register, directors' election attracts the highest opposition of all types of

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[467] CA, ss305(1) and 305(6).
[468] Kershaw, *Company Law…* (n170) 196.
[469] Buchanan and others, 'Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom' (2012) 49 American Business Law Journal 1, 6.
[470] ibid 6.
[471] During the period 2000-2007 there were on average 52 reported shareholders proposals (requisitioned and not withdrawn) per year in the UK in the public listed firms, whereas in the US there were 541 of such proposals per year in the same period. *See* ibid 16, 46.
[472] CGC, provision 18.
[473] ibid
[474] CA, s282.
[475] See page 62.
[476] CGC, provision 17.
[477] CGC, provision 20.
[478] CGC, principle J.
[479] CGC, provision 4.

resolutions voted on by shareholders.[480] When the candidate recommended by the board has received substantial opposition, directors not only have to engage in a dialogue with the company's shareholders but must also publish the outcome of the consultation.

Shareholders have a statutory right under Section 168 of the Act to remove a director at any time before the expiration of director's term of office by ordinary resolution, notwithstanding anything in any agreement between the company and the director. Directors can be removed without cause. If the shareholders wish to remove a specific director before the AGM is held, they can call for a general meeting, which as demonstrated earlier,[481] the qualified shareholders are not restricted to do.

Cumulative voting is very rarely used in UK companies.[482] However, if the company has a controlling shareholder, the Listing Rules provide special rules governing the election of independent directors.[483] Apart from gaining the approval of ordinary majority of the company's shareholders, election of any independent director of the controlled company must also be separately approved by the independent shareholders.[484]

3.3.2. Selected Corporate Governance Mechanisms

The separation of the positions of company's CEO and chairman constitute an important element of 'checks and balances' under the CG Code 2018 which recommends splitting these two roles with clearly established division of responsibilities,[485] as combination of the two positions in the hands of one person increases the likelihood of an individual having unfettered decision-making powers.[486] Around 97% of FTSE 350 companies adhere to the principle of separate CEO and chairman positions.[487]

At least half of the listed company's board of directors should comprise of independent NEDs.[488] The CG Code 2018 lists a number of criteria to be used for determining whether a director may be regarded as 'independent' such as

[480] The Investment Association, 'Public Register' <www.theinvestmentassociation.org/publicregister.html> accessed 19 March 2019.
[481] See page 62.
[482] Armour and others (n223) 80.
[483] LR, 9.2.2E and 9.2.2F.
[484] LR, 9.2.2E.
[485] CGC, provision 9.
[486] The Committee on the Financial Aspects of Corporate Governance (1 December 1992), provision 4.9 (Cadbury Code).
[487] Grant Thorton, 'Corporate Governance Review 2018' <www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/documents/corporate-governance-review-2018.pdf > accessed 10 March 2019.
[488] CGC, provision 11.

existence of a material business relationship with the company within the last three years, receiving extra remuneration from the company apart from a director's fee and a performance-related pay scheme.[489] A board tenure longer than nine years is likely to disqualify a director from being considered independent.[490]

The board is required to evaluate its own performance, those of its committees and individual directors annually using a structured process.[491] Moreover, FTSE 350 companies should have their board evaluated by the external agency at least once every three years.[492] The evaluation report can then be used by the nomination committee. Such measures put pressure on directors to discharge their duties properly because unsatisfactory performance and conduct which diverges from the company's interests may effectively lead to the removal from the board as the nomination committee may choose not to propose a specific director for re-election.

3.3.3. General Duties of Directors

Whilst the board has significant powers of management, the UK regime of directors' duties plays a central role in protecting the interests of the company and its shareholders. It is applicable to all corporate matters in which directors exercise their powers, including an unsolicited acquisition. Traditionally governed by equitable fiduciary principles and the common law of negligence,[493] directors duties have been codified in sections 171-177 of the CA 2006 in the form of seven general duties: duty to act within powers; duty to promote the success of the company; duty to exercise independent judgement; duty to exercise reasonable care, skill and diligence; duty to avoid conflicts of interests; duty not to accept benefits from third parties; and duty to declare interest in proposed transaction or arrangement.

The main objective of the company's directors should be the success of the company for the benefit of its members as a whole.[494] Section 170 of the CA 2006 leaves no doubt that directors' duties are owed to the company, not the shareholders specifically reiterating a long established principle.[495] The High

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[489] CGC, provision 10.
[490] ibid
[491] CGC, provision 21.
[492] ibid
[493] Davies and others, *Gower & Davies: The Principles of Modern Company Law* (Sweet & Maxwell 2016) 463.
[494] CA, s172(1).
[495] *Percival v Wright* [1902] 2 Ch 401; *Dawson International Pic v Coats Paton Plc* 8 [1988] 4 BCC 305, 314 ('Directors have but one master, the company').

Court in *Sharp v Blank*[496] reaffirmed that a company is distinct from its current shareholders explaining that directors' fiduciary duty is to promote the best interests of the company. The interest of the company has been understood in the UK as the interests of its shareholders, both present and future.[497] In *Sharp* the court acknowledged that although directors are not subject to any direct fiduciary duty to shareholders, the interests of the company typically align with those of shareholders.[498]

Shareholder primacy has traditionally been regarded as fundamental in the UK company law, requiring directors to prioritise shareholders' interest as a whole in their decisions regarding the operation of the company.[499] This typically translates to maximisation of shareholder wealth.[500] In order to mitigate short-termism, which is believed to be the result of the pressure to focus on shareholders wealth, the 'enlightened shareholder value' approach was incorporated into the CA 2006.[501] In order to promote the success of the company, directors need to consider the implications of their decisions in the long-term and take into account the interest of various stakeholders.[502] It thus appears that when discharging their duties directors should not focus exclusively on the short-term profitability of the company, rather a more balanced approach to the company's success must be considered. Nevertheless, the s.172(1) duty remains normally understood as a duty to maximise shareholder value as the provision refers to the company's success 'for the benefit of its members'. Directors may, or even should, consider the interest of external constituencies, yet such consideration can be made to the extent that its effect is to benefit shareholders.

Apart from acting in good faith, directors must exercise their power only for the purpose for which it was conferred. Section 171, based on the 'proper purpose' doctrine, seeks to control exercise of discretionary power by the directors.[503] The evidentiary burden is placed on the claimant to show that the primary

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[496] [2015] EWHC 3220 (Ch) [13].
[497] *Brady v Brady* [1988] BCLC 20 (CA) 40 ('The interests of a company, an artificial person, cannot be distinguished from the interests of the persons who are interested in it. Who are those persons? Where a company is both going and solvent, first and foremost come the shareholders, present and no doubt future as well.'). The decision of the CA was reversed on appeal to the HL ([1989] AC 755) but not on grounds that would affect the validity of the dictum.
[498] *Sharp* (n496) [13].
[499] Collison and others, 'Shareholder Primacy in UK Corporate Law: An Exploration of the Rationale and Evidence' (Research Report, Certified Accountants Educational Trust, 2011) <https://www.accaglobal.com/content/dam/acca/global/PDF-technical/business-law/rr-125-001.pdf> accessed 17 June 2015; Davies and others (n493) 505-510.
[500] Collison and others (n499) 7.
[501] ibid 24.
[502] Especially the firms' employees, suppliers, customers and local community.
[503] Fridman, 'An Analysis of the Proper Purpose Rule' (1998) 10 Bond Law Review 164.

purpose for which directors exercised their power was an improper one.[504] Whether the particular purpose is proper or not is a question of law which involves an objective test, whilst the question of which purposes motivated the specific director requires an inquiry into director's state of mind and is, therefore, subjective.[505] It is difficult to assess in advance the limits on directors' exercise of a particular power.[506] If limits are stated in the articles, the court's task would be straightforward. Most often, however, this is not the case.[507] For example, the purposes for which the board may exercise its authority to issue shares are generally not specified in the articles, thus the courts have applied their own interpretation.

The Privy Council in *Howard Smith v Ampol Petroleum Ltd*[508] confirmed that raising capital is not the only purpose for which a company may lawfully issue new shares as had previously been held[509]. It is, however, generally established that the issue will be invalid if the power is exercised for the purpose of preserving the boards' control over the company's management[510] or to manipulate voting power (e.g., destroying an existing majority and creating a new one)[511] even if the power is exercised in good faith with an honest believe that it would benefit the company. At the same time, provided that the board's 'substantial or primary' purpose for issuing shares is a proper one, the mere fact that the action results in the incidental, although desired, entrenchment of its position or a deprivation of a shareholder's majority voting power would not automatically invalidate the decision.[512] On the other hand, even if directors were not motivated by their own benefit and honestly believed that they acted in the best interest of the company, yet the main purpose of their action was to dilute the holding of a specific shareholder, e.g., in order to make it more probable for a competing offer to succeed, then such exercise of power would most likely be considered improper.[513] Lords Sumption and Hodge in *Eclairs Group Ltd v JKX Oil & Gas plc*[514] expressed a principled preference for a 'but for' causative test in determining whether the directors' action constitutes a

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[504] Johnston (n427) 440.
[505] Davies and others (n493) 488-9; *Eclairs Group Ltd v JKX Oil & Gas Plc* [2015] UKSC 71 [15] (Lord Sumption) (mentioning the subjective test).
[506] French, Mayson and Ryan, *Mayson, French & Ryan on Company Law* (Oxford University Press 2016) 482.
[507] Davies and others (n493) 490.
[508] [1974] AC 821, 835-8.
[509] *Fraser v Whalley* (1864) 2 Hem & M 10; *Punt v Symons* [1903] 2 Ch 506; *Piercy v Mills & Co Ltd* [1920] 1 Ch. 77.
[510] *Hogg v Cramphorn Ltd* [1967] Ch 254.
[511] *Howard Smith* (n508)*; Punt* (n509).
[512] *Howard Smith* (n508) 832.
[513] ibid
[514] [2015] UKSC 71 [17]-[23].

breach of the proper purpose rule. In a situation where there are mixed purposes underlying the board's action, the decision will breach Section 171 of CA 2006 if it would not have been taken but for the improper purpose, even if that purpose was not a dominant one.[515]

Although the 'business judgement rule' as an authoritative standard of review does not exist in the UK, directors are typically afforded a level of protection from the risk of personal liability for taking business decisions, as the courts have consistently expressed their unwillingness to second-guess directors' bona fide commercial judgments.[516] It is accepted that*:* '… it would be wrong for the court to substitute its opinion for that of management, or indeed to question the correctness of management's decision, on such a question, if bona fide arrived at.'[517]

3.4. Directors' Role in the Takeover Context

In the absence of a prospective takeover bid, the regulation of directors of listed companies is left to general company law, whereas when the target board 'has reason to believe that a bona fide offer might be imminent',[518] the Takeover Code imposes a number of rules on the board, many of which are prescriptive in nature, with the requirement of neutrality being central.

The board neutrality rule generally sets aside the board's decision making powers when hostile bids are pending in order to ensure that shareholders are not denied the opportunity to decide whether or not to sell their shares based on their own assessment of the merits of the offer.[519] Among the board's responsibilities articulated by the Code during the tender offer is analysing its terms and conditions,[520] obtaining independent professional advice on the offer[521] and, perhaps most importantly, providing a recommendation to shareholders regarding acceptance of the bid,[522] all of which are supposed to help shareholders to reach an informed decision. There is, however no requirement to conduct an auction, to carry out a market check or to negotiate better terms for the shareholders, such as a higher premium or finding a more suitable bidder.

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[515] The 'but for' test set out in *Eclairs* (n514) is of persuasive nature rather than constituting a statement of the law as the majority did not commit to the general principles set out by Lord Sumption in paras 14-24 as the issue of mixed purposes was not argued before the Court.
[516] Eg *Re Smith and Fawcett Ltd* [1942] Ch 304, 306; *Regentcrest Plc v Cohen* [2001] 1 BCLC 80 [120].
[517] *Howard Smith* (n508) 832.
[518] TC, r21.1.
[519] TC, GP 3.
[520] TC, r25.2(a).
[521] TC, r3.1.
[522] TC, r25.2.

Although the main curb on directors' conduct during the bid falls within the Takeover Code rather than the general law, their actions must nevertheless comply with the statutory statement of general duties. Questions have been posed as to the duty to advise shareholders on the bid in a situation when their interests may not perfectly align with those of the company and whether the matters to which directors are to have regard under Section 172(1) of the CA 2006 when making decisions might assist the board in advising shareholders to reject a bid. Whilst the court in *In Re a Company*[523] held that the board is under no obligation to recommend the bid just because it offers the highest price, many market participants, mistakenly believed that the Takeover Code required the target board to consider offer price as the determining factor when providing its recommendation.[524] The Note on Rule 25.2 was added to the Code in 2011 to clarify that, when providing its opinion on the offer, the board is not bound to consider the price as the determining factor nor is it precluded from taking into account any other factor which it considers relevant.

In the aftermath of the high-profile 2010 Cadbury-Kraft takeover,[525] it was suggested that the UK takeover regime favours current shareholders at the expense of the economy as a whole. Roger Carr, the Cadbury's former Chairman, noted that it is very difficult for the board in the UK to resist a premium bid even if it is not in the best long-term interest of the company to be acquired.[526] Lord Mandelson, the then Business Secretary, argued that the existing regime often creates value only for M&A advisors and short-term shareholders while making the other shareholders and stakeholders worse off.[527] The public consultation regarding the review of the Takeover Code carried out in 2011[528] identified insufficient recognition of the company's constituencies affected by the takeovers, which resulted in a range of changes including adding the mentioned earlier Note on Rule 25.2.

3.4.1. Defensive Responses to Hostile Takeovers

3.4.1.1. Pre-bid Defences

The actions of the board outside of the bid period are not restricted by the Takeover Code's neutrality rule, thus, in theory, the board could use its authority to manage the company to adopt measures with an anti-takeover effect.

[523] [1986] BCLC 383.
[524] Review of Certain Aspects of the Regulation of Takeover Bids, Consultation Paper 2011/1 (PCP 2011/1).
[525] The takeover involved a successful hostile acquisition of British iconic brand Cadbury by Kraft Foods, a US food and beverage giant.
[526] Kershaw, *Principles of Takeover Regulations* (n445) 329.
[527] Gullifer and Payne (n441) 678.
[528] PCP 2011/1 (n524).

However, the availability of particular pre-bid defensive strategies is constrained most notably by the statutory regime of directors duties, the most relevant of which in this context are those in ss. 171 and 172 of the CA 2006.

Davies suggests that decisions in cases such as *Hogg v Cramphorn Ltd*[529] and *Howard Smith*[530] come close to implying that it is always a breach of directors' duties to exercise their powers to prevent a hostile takeover, which decision should be left to shareholders.[531] Some support, however, can be discerned for the proposition that the board acting in good faith may implement certain measures to stop the takeovers damaging the interests of the company. Hart J in *Criterion Properties Plc v Stratford UK Properties*[532] seems to suggest that under certain circumstances some pre-bid defences may be accepted. The court would need to assess whether a reasonable director could legitimately have concluded that the economic threat to the company from the hostile acquisition could justify the measure adopted. The particular defensive tactic considered by the court in *Criterion Properties* was not a reasonable exercise of power as it did not create any other value to the company while exposing it to the possibility of economic damage, the extent of which would harm the company more than an outsider gaining control of the company. The Court of Appeal in *Criterion Properties*[533] avoided addressing the issue of legitimacy of takeover defences and focused on the authority of the board to sign a contract containing a 'poison pill'.[534] Thus, it could be interpreted that the doors to judicial acceptance of certain pre-bid anti-takeover measures have been left open,[535] especially if adopted defence does not involve shareholders disfranchisement e.g., does not interfere with shareholders' constitutional rights or purposely destroy majority voting power.[536]

It does not seem likely, however, that the company's continued independence and the protection of its existing business strategies would be accepted as a proper justification for the adoption of pre-bid defences implemented simply because directors believe that they would run the company better than any other acquirer. The court in *Criterion Properties* referred to an earlier case, *Cayne v*

[529] *Hogg* (n510).
[530] *Howard Smith* (n508).
[531] Davies and others (n493) 490.
[532] [2002] EWHC 496 (Ch)
[533] [2002] EWCA Civ 1883.
[534] Similarly, the issue has not been directly addressed by the HL who heard the appeal (*Criterion Properties Plc v Stratford UK Properties LLC* [2004] UKHL 28). For a brief discussion of the case see 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.
[535] Clarke, 'Regulating Poison Pill Devices' (2004) 4 Journal of Corporate Law Studies 51, 67.
[536] Such as inclusion of change-of-control clauses in key contracts which eg, put valuable assets of the company out of the reach of its shareholders.

Global Natural Resources Plc,[537] in which Megarry VC noted that the board cannot be made incapable of acting where there is a risk of the company being reduced to 'impotence and beggary',[538] and mechanisms which aim to prevent such an outcome are likely to be treated more favourably. But using this argument as a defence by the board of a listed company would be problematic because it would require a potential bidder to be on the horizon against whom the board wished to protect the company, in which case the Code's non-frustration rule is likely to apply.

Even if one assumes that acceptance of some pre-bid defences by the court may be feasible in certain circumstances, the approach of institutional shareholders towards any mechanism that intends to (or has the effect of) frustrating any future potential change of control transaction is rather hostile,[539] therefore such measures are likely to attract their opposition. Given the authority and rights of shareholders within the UK's listed companies corporate governance,[540] the boards tend to be attentive to their views.

3.4.1.1.1. Entrenchment Provisions

The scope for entrenching directors' positions on the board is limited in the UK, because as discussed earlier, a simple majority of votes in favour of a director's removal cast at the general meeting is sufficient to remove any director from the board even without cause. Although it is possible to put in place weighted voting rights which may effectively protect a director from removal,[541] such a tactic cannot be used for listed companies due to the hostility of institutional investors and the Listing Rules' restrictive approach towards such rights.[542]

Although the UK law does not prohibit staggered boards, implementation of such a defensive strategy would probably not deter hostile suitors because of the ease with which directors can be removed by shareholders at any time before expiration of their office.[543] Moreover, the recommendation of annual elections in listed companies[544] effectively restricts the possibility for adoption of staggered boards in the UK.

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[537] Unreported, 12 August 1982, [1984] 1 All ER 225.
[538] *Criterion Properties* (n532)
[539] Kershaw, *Principles of Takeover Regulations* (n445) 353.
[540] See page 62.
[541] *Bushell v Faith* [1970] AC 1099 (HL) 447-8.
[542] See page 166.
[543] See Part 3.3.1.
[544] See page 63.

3.4.1.1.2. Golden Parachutes

In theory*,* golden parachutes, as long as adopted outside of the period of bid imminence are generally not prohibited in the UK, even if they may result in deterring potential acquirers by making the deal more expensive. Their anti-takeover effect remains limited nevertheless because both law and corporate governance practices effectively restrict the amount payable to executive directors in case of removal as a result of change of control. Firstly, any arrangement regarding loss of office payments must be disclosed in the remuneration policy proposal[545] which then requires shareholder approval.[546] If no such arrangement is provided for in the remuneration report, a resolution of the company's shareholders is required to approve any specific non-contractual payment for loss of office.[547] The position of institutional shareholders is clearly not in favour of such payments.[548]

Although directors' contractual entitlements to compensation for loss of office do not generally require specific shareholder approval, they must nonetheless be consistent with directors' remuneration policy. Golden parachutes clauses included in directors' service contracts often specify a lump sum payment by way of liquidated damages representing compensation for dismissal without the proper due notice.[549] Whilst such provisions risk being unenforceable under general contractual principles as they may amount to being a penalty clause,[550] the Court of Appeal in *Murray v Leisureplay plc*[551] confirmed that a golden parachute clause of one year may be enforceable. The court also provided that even if the lump sum exceeds the likely amount of contractual damages on dismissal it does not necessarily render the terms penal unless the sum payable is 'extravagant and unconscionable'.[552] Despite their potential availability, such clauses are often inappropriate for listed companies. Firstly, they potentially contravene the CG Code, which prescribes the remunerations committee's responsibility to ensure that compensation commitments in directors' service

[545] The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, SI 2013/1981, sch 8.
[546] CA, s439A.
[547] CA, s226C(1)(b).
[548] 'Joint Statement on Executive Contracts and Severance by the Association of British Insurgence and the National Association of Pension Fund' (18 February 2008) provision 3.9 (ABI and NARF's Joint Statement) <www.ivis.co.uk/media/5896/ABI_NAPF_Joint_Statement_14feb2008_2_v_5.pdf> accessed 12 June 2017.
[549] Emir, *Selwyn's Law of Employment* (Oxford University Press 2014) 409.
[550] ibid; *See* the Supreme Court's decision in the combined cases of *Cavendish Square Holding BV v Talal El Makdessi* and *Parking Eye Ltd v Beavis* [2015] UKSC 67 which set out a new approach to the identification of penalty clauses.
[551] [2005] EWCA Civ 963.
[552] ibid

contracts should be robust to reflect the obligation to mitigate loss.[553] Secondly, institutional shareholders generally do not support the liquidated damages approach involving payment of a lump sum in the event of a change of control transaction calling for phased payments instead, in monthly instalments spread over the notice period.[554]

Since shorter duration of contract usually reduces the value of a severance payment, the Cadbury Commission in 1992 recommended setting a limit to the length of directors' service contracts[555] in order to control the size of severance payments. The CG Code provides that both notice and contract periods of executive directors should be one year or less. [556] A service contract longer than 2 years is subject to shareholder approval as provided in the CA 2006.[557] Thus, adoption of powerful golden parachutes without shareholders consent is of limited availability in the UK.

3.4.1.1.3. Shareholder Rights Plan (US-style Poison Pill)

Although, in theory, UK boards have power to devise a shareholder rights plan, its implementation in practice is highly constrained. Since the US-style poison pill involves the issuance of rights to subscribe for shares, authorisation in the articles or by a shareholders' resolution is required.[558] Such authorisation must state the maximum number of shares to be allotted and cannot be given for a period longer than five years.[559] Listed companies typically provide the board with the annual rolling grants of authority to allot shares and to grant rights to subscribe for shares.[560] Yet rolling grants of authority would normally not allow the issue of a sufficient number of shares to allow for a shareholder rights plan, so a separate shareholder authorisation would likely be necessary to grant warrants.[561] It is, therefore, not possible to put in place a poison pill without shareholder involvement at some stage of the process.

Although an earlier discussion[562] showed that the shares can be issued for a reason other than to raise capital, in the absence of corporate benefit constituting a dominant purpose for adoption of a shareholder rights plan, a decision to construct the plan would most likely amount to the breach of duty under Section

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[553] CGC, provision 39.
[554] ABI and NARF's Joint Statement (n548) provision 3.10.
[555] Cadbury Code, provision 4.41.
[556] CGC, prov 39.
[557] CA, s188.
[558] CA, s551(1).
[559] CA, s551(3).
[560] Gerner-Beuerle, Kershaw and Solinas (n534) 610.
[561] ibid 610.
[562] See page 67 .

171(b) of the CA 2006. *Criterion Properties* at first instance suggested that pre-bid defences will be rejected by the court if adopted purely to entrench control without creating any other value to the company.[563] Even if the board honestly believes the company would benefit from its continued leadership, the rights plan's adoption would most likely be deemed to be for a collateral purpose, especially if the pill would deter all bidders indiscriminately. Although the possibility remains that some pre-bid defensive measures adopted prior to the offer launched by the predator bidder who may damage the interests of the company may be accepted by the court,[564] such measures deployed by the board of listed companies would most likely be caught by the Takeover Code's neutrality rule set out in Rule 21.1 if adopted to protect against a specific bidder.

The protection of the company's trading losses (which are similar to the NOLs in the US[565]) may constitute an acceptable reason for a rights plan in the UK. A company that undergoes a major change in the nature or conduct of its trade in the three years following a change of ownership cannot carry forward its trading losses from the date of ownership change,[566] which means that any pre-acquisition trading losses will not be available to offset against profits. In this light, a poison pill deterring change of control transactions to safeguard the corporate benefit in the form of trading losses could arguably be justified. Yet, since the law has recently been reformed to restrict transactions aimed at 'loss buying' by e.g., increasing the relevant period from three to five years,[567] the validity of the purpose of trading losses' protection could be more difficult to support.

Even if the board somehow assembles an effective shareholder rights plan 'on a clear day', it would still likely be in contravention of the board neutrality rule to keep the poison pill in place once an imminent bid appears on the horizon. In his discussion on the legality of the US-style poison pills in the UK, Kershaw suggests that since the non-frustration requirement imposed by Rule 21.1 only applies to an 'action', once the pill is in place no action is theoretically taken by the board during the bid period.[568] At the same time, Kershaw recognises that a decision to refuse to redeem the pill in order to allow the potential acquirer to

[563] Clarke (n535) 67.
[564] See page 70.
[565] See page 42.
[566] EY, 'UK Reforms Corporation Tax Loss Relief Rules, Global Tax Alert' (12 December 2016) 3 <> accessed 12 November 2018.
[567] 'Corporation Tax: Reform of Loss Relief' (Policy Paper, 5 December 2016) <www.gov.uk/government/publications/corporation-tax-reform-of-loss-relief/corporation-tax-reform-of-loss-relief> accessed 12 November 2016.
[568] Kershaw, 'The Illusion of Importance: Reconsidering the Uk's Takeover Defence Prohibition' (2007) 56 International and Comparative Law Quarterly 267 273-4.

make a bid amounts to an action, which results in denying shareholders the right to decide on the offer.[569] On the other hand, if a no-hand pill was put in place before the start of the takeover contest the board would have no ability to redeem the pill, thus its conduct, quite likely, would not violate the neutrality provision under the Takeover Code. Yet, constructing such a device would almost certainly constitute a breach of duty under Section 171 and perhaps even under Section 172 of the CA 2006, unless the pill was put in place by the company's former board.

Last but not least, the UK's shareholders have been generally hostile towards anti-takeover measures, which combined with the extensive shareholder decision rights, significantly decreases defensive potency of the US-style poison pill in the UK.[570]

3.4.1.2. Post-bid Defences

The Takeover Code's board neutrality rule is strictly applied and the purpose of the board's action remains irrelevant as long as such action may have a frustrating effect on the bid, since the rule looks to its consequences, not its purpose.[571] A good faith and an honest belief that a defensive response was in the best interest of the company because the offer appeared to be coercive or undervalued is not a derogation from the prohibition under Rule 21.1. Since even actions used for a reason unrelated to a takeover bid which have a frustrating effect are deemed unacceptable, directors with doubts regarding the permissibility of a certain act should consult with the Panel,[572] even just to safeguard against unintentional violation of the strict neutrality rule. The approach of the non-frustration rule under the Takeover Code contrasts starkly with the proper purpose rule.

Yet, rather than putting an absolute bar on the use of the post-bid defences, the Takeover Code gives shareholders decision rights regarding takeover defences. If the target board wants to defend the company against a specific bidder, it can seek shareholder approval of the proposed defensive action at the general meeting, providing shareholders with as much information as possible regarding the reasons behind the contemplated action.[573] It appears that shareholders cannot offer the board a blank cheque permitting the use of defensive actions *ex-ante*, the permission must be given in a context of a specific bid.

[569] ibid 273-4.
[570] ibid 293-4.
[571] Kershaw, *Principles of Takeover Regulations* (n445) 939.
[572] TC, r21.1(b).
[573] TC, r21.1(d) and r21.1(note 1).

The list included in Rule 21.1(a) sets forth a number of actions strictly prohibited under the Takeover Code, such as the issuance of new shares out of treasury or the company's purchase of its own shares, issuance or granting options in respect of any unissued shares, disposing of or acquiring assets of a material amount,[574] and entering into contracts in any context other than in the ordinary course of business. For example, preparation of new contract or amending an existing one to include significantly improved terms in regard to severance pay for the loss of office is prohibited without shareholder approval.[575]

If the board believes that a particular acquisition would not promote the success of the company because, e.g., its business would be damaged by the acquirer, apart from seeking shareholders' consent at the general meeting, it can legitimately attempt to defeat the offer through a negative recommendation of the bid sent in the so-called 'defence document' addressed to the shareholders pursuant to Rule 25.1. The board may seek to convince shareholders about the inadequacy of the offer, advising them to reject it. Whilst the board may argue that the offer undervalues the company providing optimistic forecasts of profitability under its continuing leadership, such forecasts must always comply with a number of strict rules in Rule 28 of the Code. Since each document circulated, information published, or statement made during the offer period must be prepared with the highest standards of care and accuracy,[576] the board's recommendation to reject the offer must be based on relevant and adequate information and must be stated in a clear and concise form.

It should also be stressed that the Takeover Code guards against the situation where it is open to directors to adopt frustrating actions within the window period when the board knows a potential intention to make the bid and when it is evident that the bid will be launched.[577] Whereas the earliest starting point of the board neutrality requirement provided for in the first version of the Code began when the offer *was* imminent, in the current version it begins when the board believes that the offer *might* be imminent, which extends the period of the neutrality rule[578] and effectively limits the board's ability to defend against a specific takeover attempt.

[574] To determinate a material amount, the Panel will have regard to the aggregate value of the consideration to be received or given compared with the company's market value, the value of the assets to be disposed/acquired compared with the company's assets and the operating profit attributable to the assets being considered. TC, r21.1(note 2).
[575] TC, r21.1(note 5).
[576] TC, r19.1.
[577] Which may be the case under the Takeover Directive, arts 6(1) and 9.
[578] Kershaw, *Principles of Takeover Regulations* (n445) 323.

It is worth noting that, as argued by Kershaw, even in the absence of the neutrality rule, the possibility of using anti-takeover measures in the UK would have nevertheless been limited; [579] firstly, because the majority of defences at some stage would require shareholders' approval anyway and secondly, because directors' ability to employ such measures would have been constrained by directors general duties.

3.4.1.2.1. White Knight

Since the Takeover Code does not prohibit soliciting alternative bids, a white knight defence is available to the target board under the UK's takeover regime. All bidders must be treated fairly, and any information provided to the white knight must be provided to the hostile bidder upon request.[580] The possibility to protect the agreement with the friendly bidder is however limited, as companies are not allowed to enter into any deal protection measures and the highest break-up fee available only with the Panel's consent is 1% of the value of the transaction. The target board will normally be granted the Panel's permission to enter into an inducement fee arrangement with the white knight.[581]

3.4.1.2.2. Tactical Litigation and Lobbying the Authorities

Although the scope for use of litigation as a defensive tactic has traditionally been limited under the UK's takeover regime, putting the Panel's authority on a statutory footing brought about fears of tactical litigation.[582] Since the timetable of the tender offer provided by the Takeover Code is rigorously outlined and followed in practice,[583] any delay caused by the litigation could frustrate the bid without giving the shareholders a chance to tender their shares. Therefore, a number of provisions in Part 28 of the CA 2006 prevent tactical litigation, preserving the efficacy of the takeover regime. Firstly, no party, except the Panel, has a right to seek an injunction to prevent a person from contravening (or continuing to contravene) a requirement imposed by the Takeover Code.[584] Moreover, failure to comply with an obligation of the Code does not give any right of action for breach of statutory duty.[585] To promote certainty, a transaction will not be set aside just because it is in breach of the Code or because of non-compliance with the ruling of the Panel.[586]

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[579] ibid 353-5.
[580] TC, r21.3.
[581] TC, r21.2(note 1).
[582] Muston, 'Coping with Change : A View from the Uk Takeover Panel' in Munch and Skog (eds), *The Securities Council 25 Years - an Analogy* (Capital Markets Board 2011) 78.
[583] Armour and Skeel Jr (n442) 1746.
[584] CA, s955.
[585] CA, s956.
[586] Hudson, Girvin and Frisby, *Charlesworth's Company Law* (Thomson Reuters 2010) 790.

To avoid delay, the Panel adopted a speedy system of internal appeals conducted in the course of the bid.[587] The Panel's rulings are therefore seldom challenged other than through its own appeal body. Although Panel's decisions are subject to judicial review, the reluctance of the courts to interfere is evident.[588] The 'after-the-event' approach[589] established by the Court of Appeal in *R v Panel on Takeovers and Mergers, ex p Datafin plc*[590] further minimises an opportunity for frustrating the takeover through civil litigation. It has been also made clear by the Panel in *Consolidated Gold Field plc*[591] that litigation could amount to a frustrating action and consequently is unacceptable.

The Panel, however, distinguished litigation from lobbying of the relevant authorities and participating in administrative proceedings, which are generally not prohibited under the UK's takeover regime.[592] The target board may attempt to lobby the competition authority to secure reference for a detailed review. Although the offer does not lapse automatically if it is referred to the Phase 2 CMA investigation[593] the risk of non-completion increases significantly[594]. Thus, where an offer comes within the statutory provisions or a possible Phase 2 CMA reference, the offer must be made subject to a condition if there is such reference before the first closing date or the date when it becomes unconditional as to acceptances.[595] Although lobbying the CMA does not guarantee avoidance of the takeover, the lapsing of the offer may provide the board with breathing space and extra time to strengthen its defences or may lead to emergence of a more welcome bidder, or the bidder may simply lose interest as a result of the reference for review.[596] Yet, even the actions which are generally allowed under the Code have their limits - the Panel confirmed in *BAT Industries plc*[597] that in some cases lobbying the authorities is 'capable of contravening the non-frustration rule'.[598] At the same time, participation in administrative proceedings

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[587] See page 59.
[588] Eg *R v Panel on Takeovers and Mergers, ex p Datafin plc* [1987] QB 815, CA; *R v Panel on Takeovers and Mergers, ex p Guinness Plc* [1990] 1 QB 146, CA.
[589] Davies and others (n493) 922.
[590] *Datafin* (n588) (the courts should intervene 'if at all, later and in retrospect by declaratory orders which would enable the Panel not to repeat any errors').
[591] *Consolidated Gold Field plc*, 1989/7.
[592] *BAT Industries Plc*, 1989/20.
[593] Phase 2 is a reference for a more detailed investigation of o transaction by the competition authority. In Phase 2 the CMA must decide whether a transaction may lead to Substantial Lessening of Competition.
[594] See eg, Asda/Sainsbury's merger which has been blocked by the CMA after nearly a one-year investigation. 'CMA Blocks Merger Between Sainsbury's and Asda' (Press Release, 25 April 2019) < https://www.gov.uk/government/news/cma-blocks-merger-between-sainsburys-and-asda > accessed 30 April 2019.
[595] TC, r12(a).
[596] *BAT Industries Plc* (n592).
[597] ibid
[598] ibid

initiated by regulators in which the target company usually has an obligation to cooperate would typically not constitute a frustrating action even if the target directors' participation was very thorough, even 'over-diligent'.[599]

3.5. General Provisions Regulating Takeover Bids

The purpose of the Takeover Code is to ensure that shareholders in a target company are treated fairly and are not denied an opportunity to decide on the merits of a takeover offer, and that shareholders of the same class in the target company are afforded equivalent treatment by a potential acquirer.[600] What is particularly important in regard to the regulation of takeover defences is the explicit statement that the purpose of the Takeover Code is neither to facilitate nor to impede takeovers.[601] The Code is not concerned with the financial or commercial advantages or disadvantages of an offer, these matters being left for the target firm and its shareholders.[602] Rather, it aims to provide an orderly framework within which takeover activities may be conducted[603] with protection of the shareholders as its core objective.

3.5.1. Right to Information

Providing target shareholders with sufficient information to enable them to reach a properly informed decision on the bid is one of the General Principles of the Takeover Code.[604] The right to information is fulfilled through mandatory disclosure provisions which require investors buying shares in the company on the open market to disclose their stake. In accordance with the DTR, an investor who purchases 3% and every whole 1% thereafter of the company's voting rights must disclose its interest within two trading days.[605] The Takeover Code imposes further obligations on shareholders during the tender offer requiring holders of 1% or more of any class of the company's securities to make a disclosure containing details of their position and interest in the target and any dealings in its securities.[606]

The bidder must also provide target shareholders with a substantial amount of information regarding the offer. Despite great importance attached by the Panel to Rule 19.1 requiring each statement made during the offer to be prepared with the highest standard of care and accuracy, the quality and detail of information

[599] ibid
[600] TC, Introduction 2(a).
[601] ibid
[602] ibid
[603] Response Statement 2011/1, 'Review of Certain Aspects of the Regulation of Takeover Bids' (RS 2011/1).
[604] TC, GP 2.
[605] DTR, r5.1.2 and r5.8.3.
[606] TC, r8.3.

included in the acquirer's offer document had often been considered as not fully adequate.[607] Perhaps the most notorious criticism expressed publicly by the Panel is that of Kraft for the standard of information provided during the offer to Cadbury's shareholders.[608] In response to the public consultation following the Kraft/Cadbury takeover, the Panel proposed amendments to the Code designed to improve the quality of the acquirer's disclosure. As a result, the acquirer is now required to explain in its offer document the long-term commercial justifications for the acquisition outlining its strategic plans for the target, intentions regarding its future and likely repercussions on the company's employees.[609] In 2014 during the Pfizer's attempt to secure a deal with AstraZeneca,[610] Pfizer made a public statement pledging to invest in the UK's innovation and scientific research.[611] It described the commitments as 'legally binding' which it intended to comply with for the period of five years following the acquisition.[612] This sparked another public discussion on the Panel's power to hold the bidders accountable for their statements of intention and whether the law should be reformed to provide regulators with greater powers to pursue non-compliance.[613] After the conclusion of the consultation, in 2014 the Takeover Code introduced a framework for distinguishing 'commitments' from mere statements of intentions.[614]

In post-offer intention statements (POISs) the acquirer *intends* to take or not to take a certain action after the bid, whereas in post-offer undertakings (POUs) the acquirer *commits* to those undertakings. POUs must be complied with for a specified period of time unless a qualification or condition set out in the undertaking applies,[615] the POISs are generally required to be accurate at the time they are made.[616] The acquirer must seek consent of the Panel if, during the period of 12 months[617] following a successful acquisition, it decides to diverge

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[607] *Cadbury Plc*, 2010/14.
[608] ibid
[609] TC, r24.2; RS 2011/1 (n603).
[610] The proposed takeover, with tax avoidance as one of the main motives behind it (transaction was structured to take advantage of tax rules on the repatriation of profits earned overseas), initiated a debate in the UK on the political oversight of takeovers. Pfizer had a reputation of a bidder known for efficiency cuts to its acquired targets what caused many to worry about the cuts to R&D jobs and their negative influence on the UK's economy. Zerdin, 'United Kingdom' in Zerdin (ed), *The Mergers and Acquisitions Review* (Law Business Research 2015) 802- 829.
[611] 'Memorandum from Pfizer to the Business, Innovation and Skills Committee and the Science and Technology Committee of the House of Commons' (12 May 2014) <https://www.rns-pdf.londonstockexchange.com/rns/8315G_-2014-5-12.pdf> accessed 15 August 2015.
[612] ibid
[613] Wright, *A Practitioners Guide to the City Code on Takeovers and Mergers 2016/2017* (Sweet&Maxwell 2016).
[614] 'Post-offer Undertakings and Intention Statements', Response Statement 2014/2.
[615] TC, r19.5(e)-(f).
[616] TC, r19.6(a).
[617] unless otherwise stated in the offer document.

from its POISs, otherwise it must publicly explain its reason for departing from the POIS.[618] The Panel's ability to monitor compliance with POUs has been strengthened by the Code by equipping the Panel with a right to appoint an independent supervisor to oversee the bidder's compliance and to require periodic written reports to the Panel.[619] In 2017 the Code was amended once again to require the acquirer to provide its intentions regarding the target firm's R&D functions, the balance of the skills and functions of the target's executives and employees as well as the location of the target's headquarters.[620]

Perhaps even more importantly from the perspective of target shareholders, the Takeover Code requires the target board to provide the company's shareholders with sufficient information and advice. When advising shareholders, the board must express its views on the effects of implementation of the bid on the interests of the company and its employees as well as the acquirer's strategic plans regarding the company as outlined in its offer document.[621] The board's circular must also include the substance of the advice given to the board by an independent financial advisor hired by the board.[622] Compliance with Rule 19.1 of the Takeover Code ensures that the target's report is prepared with the highest standard of care, which is of great importance to the orderly conduct of takeovers.

3.5.2. Right to Equal Treatment

Founded on the principle of equal treatment of shareholders of the same class, the Code recognises that the takeover regime is designed mainly to ensure that all target shareholders are treated fairly in the course of the offer and that shareholders of the same class are afforded equivalent treatment by an acquirer.[623]

Tender offers launched under the Code should be for all the outstanding shares in the target, unless the Panel consents to a partial bid.[624] Permission will not normally be granted if an offer could result in the bidder carrying more than 30% but less than 100% of the target's voting rights if in the period of 12 months prior to the acquisition or at any time after the partial offer was reasonably in contemplation the bidder has acquired, selectively or in significant numbers,

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[618] TC, r19.6(b).
[619] TC, r19.5(h)-(i).
[620] TC r24.2; 'Statements of Intention and Related Matters', Response Statement 2017/2.
[621] TC, r25.2(a).
[622] TC, r25.2(b).
[623] TC, Introduction 2(a).
[624] TC, r36.1.

interests in target's shares.[625] If the Panel's consent for a partial bid has been obtained, shareholders must be able to accept the offer on a pro rata basis.[626] Moreover, a partial offer for 30% or more voting rights requires separate approval by shareholders holding a majority of company's voting rights who are independent from the acquirer.[627] These provisions prevent acquirers avoiding the mandatory bid rule (MBR) by acquiring a significant stake, even one close to the MBR threshold, and then launching a voluntary partial offer which would deny shareholders a stake in the control premium and a chance to exit the company on fair terms to avoid a minority shareholder status following the change of control.

Perhaps the strongest manifestation of the equality principle is the mandatory bid rule, introduced to the Takeover Code in 1972 as a response to the high number of creeping acquisitions in which not all shareholders had a chance to be acquired. [628] Pursuant to Rule 9.1, any party acting in concert or alone that purchases 30% of the company's voting rights must extend its offer to all holders of any class of equity share capital. The Panel may agree to waive the requirement for a general offer in limited circumstances, such as where the target company is in such a serious financial position that only an urgent rescue operation involving the acquisition of existing shares by the rescuer would be able to save it.[629]

The force of the MBR does not stem merely from the obligation to make a full offer, but also from strict requirements related to the price to be paid by the acquirer.[630] The same price must be offered to all shareholders within a class[631] and the consideration must be made in cash or cash alternative at no less than the highest price paid for the shares of the relevant class within 12 months preceding the announcement of the offer.[632]

3.5.3. Squeeze-out and Sell-out Rights

The purpose of sell-out and squeeze-out provisions is 'to strike a balance between the interest of the bidder … and the interests of the minority who refused the offer.'[633] Shareholders remaining as such following a successful bid

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[625] TC, r36.2.
[626] TC, r36.7.
[627] TC, r36.5.
[628] Muston (n582) 73.
[629] TC, r9 (note 3 on dispensations from r 9); *Ronson*, 2004/4 (Panel waiving the MBR obligation on this ground).
[630] Davies and others (n493) 962.
[631] TC, r14.
[632] TC, r9.5.
[633] *Re Greythorn Ltd* [2002] 1 BCLC 437, 447.

in which the acquirer accumulated at least 90% of the voting rights may force the acquirer to buy them out.[634] Dissenting shareholders are thus provided with an exit on the same terms as those who tendered their shares. Similarly to the requirement to launch an equal and full offer to all shareholders, the sell-out right relieves the shareholder from the pressure to accept a sub-optimal offer out of fear of potential minority status.

Correspondingly, dissenting shareholders are obliged to sell their shares to the acquirer if the tender offer reaches the acceptance level of at least 90% of shares to which the offer relates (and, where relevant, 90% of the voting rights).[635] Although pursuant to Section 986(1) CA 2006 dissenting shareholders can object in court to the squeeze-out, the UK courts will typically allow the transaction to progress without requiring a higher consideration than the one provided in the offer unless the dissenting shareholder can demonstrate that the offer price was unfair.[636] The burden is a heavy one, since 90% of seemingly informed target shareholders considered it fair. The shareholder may be able to satisfy the burden if, for example, it can establish that the offer is not indicative of fairness because those who accepted the bid were not independent of the acquirer.[637]

3.5.4. Right to Sufficient Time to Make Decisions

The takeover offer must remain open for at least 21 days following the date on which the offer document was published[638] and at least 14 days following a revision of the terms of the offer. The shareholders must also have a chance to accept the offer for not less than 14 days following the date on which it became unconditional as to the acceptances.[639]

Shareholders who tendered their shares are entitled to withdraw their acceptance from within 21 days after the first closing date of the initial offer if the offer has not become unconditional as to acceptances by such date.[640]

3.5.5. The Role of Financial Advisors

Pursuant to Rule 3.1 of the Takeover Code, the target board must obtain competent advice from an independent financial advisor whether the financial

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[634] CA, s983.
[635] CA, s979.
[636] CA, s986(4)(a).
[637] Payne, 'Minority Shareholder Protection in Takeovers: A Uk Perspective' (2011) 8 European Company and Financial Law Review 145, 148.
[638] TC, r31.1.
[639] If the offer is unconditional as to the acceptances from the outset, there is no requirement of 14 days extension. TC, r31.4.
[640] TC, r34.1.

terms of the offer are fair and reasonable. The substance of the advice must then be communicated to shareholders.

In order to ensure that the advice given is objective, Rule 3.3 outlines the independence standard. If one division within the corporate group of a financial advisor is engaged by the acquirer, then no other division is permitted to act for the target. The advisors with a recent advisory relationship with the acquirer may not advise the target.[641] Moreover, some fee arrangements between the target and the financial advisor, such as fees payable only on the failure of the bid, create a potential conflict of interest and as such they disqualify the advisor from being regarded as sufficiently independent.[642]

The role of financial advisors is not limited to providing opinion on the fairness of the bid's terms. They are also responsible for ensuring, so far as they are reasonably able, that directors are aware of and comply with their responsibilities under the Takeover Code.[643] Notes on Rule 19.1 mandate that advisors should provide guidance to the board regarding any information it intends to provide to the company's shareholders and to the public during the offer period, including media interviews and publications on social media. The importance of the role of financial advisor in assisting directors in presenting their views and ensuring that full and sufficient information is circulated to shareholders has been stressed by the Panel multiple times.[644]

A financial advisor's failure to discharge its duties under the Code may result, depending on the nature of the breach, in the Panel issuing a statement publicly criticising the advisor.[645] Moreover, liability to the target company and even the target shareholders[646] could arise for negligent misstatement in relation to statements made by the advisor in the course of a tender offer.[647]

3.5.6. Other Provisions

After a consultation process run by the Panel, several changes were introduced to the Code in order to address concerns that the UK's takeover regime allows

[641] TC, r3.3(note 1).
[642] TC, r3.3(note 3).
[643] TC, Introduction 3(f).
[644] Nyombi, *Uk Takeover Law and the Board Neutrality Rule* (Wildy, Simmonds & Hill Publishing 2017) 84.
[645] Eg *Cadbury Plc*, 2010/14 (an advisor publicly criticised for failing to discharge fully its responsibilities under r19.1(note 1); and *Asia Resource Minerals Plc,* 2015/15 (an advisor publicly criticised for the conduct which gave rise to a number of breaches of the TC's key provisions).
[646] Even though the advice is given to the board of the target company, it is prepared for inclusion in a document addressed to its shareholders.
[647] Cooke, 'Duties and Liabilities of Directors and Advisers of the Bidder and Target, *Practical Law* (01 January 2019) < https://uk.practicallaw.thomsonreuters.com/3-107-3616?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk > accessed 10 January 2019.

the bidder to obtain a tactical advantage over the target company.[648] One of the identified problems was the existence of prolonged 'virtual bids', where potential acquirers would signal an interest in the company without making a firm offer.[649] The target was negatively affected by 'virtual bids' because of their destabilising effect on company's affairs, weakening the target's board's negotiating position with an acquirer. Moreover, such bids generally lead to significant changes in the composition of the shareholder base before the bid is officially announced,[650] because some shareholders sell to short-term buyers who hope that the bidder will make an offer at some point, allowing them to realise short-term capital gains, even if doing so may prejudice the interest of the company as a whole.[651] To counter this problem, the Takeover Code implemented certain solutions. Firstly, whenever it is known or there are rumours regarding a potential bid, the target company is required to identify the potential bidder.[652] When such a bidder has been publicly identified it automatically becomes a subject to a 28 day 'put up or shut up' (PUSU) deadline,[653] by the end of which it is required to either make an offer[654] or, if it announces that it does not intend to make an offer, to 'walk away' for at least six months.[655] The PUSU provisions, as demonstrated in the Pfizer-AstraZeneca case, provide target boards with some level of protection and significant leverage against a hostile acquirer.[656] Given the various tasks required to prepare a tender offer complying with the requirements of the Takeover Code, it would be a very challenging mission to launch a bid within the strict 28 day period. The Panel may consent to an extension of the deadline at the request of the target company,[657] which is obviously extremely unlikely in the case of a hostile takeover. The fact that this period can only be extended with the support of the target board allows directors of the target company to negotiate with a potential bidder from a position of strength. During the six-month period the bidder is not allowed to make any offer nor to acquire any interest in the target and it cannot make any statement causing rumours regarding a potential offer or take any steps towards a potential acquisition.[658]

[648] Review of Certain Aspects of the Regulation of Takeover Bids, Statement 2010/22.
[649] ibid
[650] ibid
[651] ibid
[652] TC, r2.2 and 2.3.
[653] TC, r2.6(a).
[654] TC, r2.6(a)(i).
[655] TC, r2.6(a)(ii) and r2.8.
[656] Mor, *Contested Mergers and Takeovers. Briefing Paper Number 5374* (House of Commons Library, 2018) 32-4.
[657] TC, r2.6(c).
[658] TC, r2.8.

The position of target board was further strengthened in 2018 as a result of the Takeover Code's amendment[659] providing that the acquirer may only publish an offer document within the 14 days after the announcement of the firm intention to make an offer if it obtained the consent of the target board.[660] It gives the target directors additional time to prepare its response document to the target shareholders.

3.6. Conclusions

The UK's approach to regulating corporate governance of its public companies is characterised by shareholder primacy. The board neutrality rule adopted in the Takeover Code is a reflection of the shareholder-oriented model of company law developed in the UK with certain decision rights as its fundamental norm. The board's role in takeovers is minimised, and the use of post-bid defences strictly prohibited, unless specifically approved by the shareholders of the target company. Some limited range of pre-bid anti-takeover measures are, in theory, allowed under certain circumstances subject to general law and directors duties, especially duties under Sections 171 and 172 of the CA 2006. The courts, however, remain rather hostile towards the board's use of anti-takeover mechanisms, in particular when they involve disfranchising shareholders by manipulating their voting power.

When a listed company in the UK is faced with a takeover offer, its shareholders are very well protected by the Takeover Code. Thanks to the strict application and effective enforcement by the Panel of e.g. the mandatory bid rule, sell-out rights and information rights all target shareholders have a chance to obtain their share in the control premium and are given the opportunity to exit the company on fair terms to avoid a minority shareholder status following the takeover. All they need to be concern about is making a decision whether to sell their shares based on the extensive information provided. The board's role is to assist shareholders with this decision by providing reliable recommendation on the bid.

[659] Instrument, 'Statements of Intention and Related Matters', 2017/5.
[660] TC, r24.1.

CHAPTER IV Introduction to China's Legal System

China's takeover regulations must be viewed in a broader context of the country's legal system. In order to conduct a comprehensive analysis of a takeover regime and, even more so, to put forward viable reform recommendations it is indispensable to understand China's basic legal and institutional framework, the tradition of legal transplantation, the forces that have shaped China's legal development, the political and socio-economic factors presently influencing China's legal system as well as fundamental practices and issues associated with the courts and supervisory authorities.

4.1. Historical Development of the Legal System

China's modern legal system has been built on various influences that comprise philosophies deeply rooted in Chinese culture such as Daoism[661], Legalism[662] and Confucianism.[663] Confucian cultural tradition, which advocated that an individual should be guided by *li* (virtue or propriety) rather than by *fa* (the law),[664] dominated Chinese legal philosophy for over 2000 years.[665] Codification of the law in ancient China, predominantly penal in nature, was first undertaken during the Qin Dynasty (221–206 BCE) and then continued by Tang (618–907), Song (960–1279), Ming (1368–1644), and Qing (1644–1912) dynasties. The Chinese courts infrequently had occasion to exercise jurisdiction over commercial disputes because civil cases were traditionally settled through either mediation or arbitration.[666]

After the Opium War in the mid-19th century, the Qing Dynasty encountered internal and external pressures to engage with the task of modernisation.[667] Western states pledged to relinquish extraterritorial rights and made a promise to assist China in reforming its laws to make them more compatible with foreign standards.[668] The process is sometimes called 'westernisation of law in the name

[661] Daoism has its roots in teaching of Lao Zi and Zhuang Zi (5th and 4th century BCE). It advocated that a government should not be complex, should not interfere in people's lives, should not emphasize luxury and wealth, and, if practical, should be inactive. Zimmerman, *China Law Deskbook: A Legal Guide for Foreign-Invested Enterprises* (American Bar Association 2005) 38-39.
[662] Legalism has its roots in teaching of Shang Yang (338 BCE). The underlying assumption was that humans are selfish and evil and the ruler could not therefore govern efficiently without a set of clear draconian laws serving to control the masses and preventing social disruption. See ibid 39-40.
[663] Li, 'Philosophical Influences on Contemporary Chinese Law' (1996) 6 Indiana International & Comparative Law Review 327.
[664] Zimmerman (n661).
[665] Zhang, *The Constitution of China: A Contextual Analysis* (Bloomsbury Publishing 2012) 6.
[666] Zimmerman (n661) 41.
[667] Wu, 'How Has China Formed Its Conception of the Rule of Law? A Contextual Analysis of Legal Instrumentalism in Roc and Prc Law-Making' (2017) 13 International Journal of Law in Context 277.
[668] Chen, 'The Transformation of Chinese Law-from Formal to Substantial' (2007) 37 Hong Kong Law Journal 689, 700.

of modernisation'.[669] Various foreign systems were examined in the process including those of Japan, Continental Europe and the US. In the end, Japan's regime was chosen as a model system due to the proximity in terms of the history, culture and ideology as well as Japan's former transformation to one of the world's most powerful countries thanks to, amongst other matters, the introduction of Western-style (mostly German) legal reforms.[670] At the beginning of the 20th century, the Chinese government began drafting series of law codes based on international legal norms. German law in particular was treated as a paradigm in the development of a modern civil law in China.[671] Although the Civil Code of the Great Qing was drafted in 1911, it has never been implemented due to the overthrowing of the Qing Dynasty during the Xin Hai Revolution.[672]

The government of newly created Republic of China, controlled by the Kuomintang (KMT), decided to preserve the old legal system, modernising it with new codes.[673] Continuation of the Qing's law reform legacy meant acceptance of Western influence on Chinese law. Together with the establishment of a Continental-style judicial system, the legal regime in China resembled that of the 'West' in its form, terminologies and notions. Yet, the foreign doctrines and institutions were not adopted indiscriminately, rather, the KMT law reform constituted a balanced process of westernisation and modernisation which managed to maintain Chinese traditions and customs.[674]

A takeover of control by the Chinese Communist Party (Party or CPC) and creation of the People's Republic of China (PRC) in 1949 marks the abolition of the entire body of the existing legal system in Mainland China.[675] A socialist legal system was set up in the 1950s, with the first PRC's Constitution enacted in 1954, which was based on the Soviet Union's system: state power and public ownership played a huge role in all areas of life.[676]

In the late 1970s, after a breakdown in the legal system due to the Cultural Revolution, China began to slowly implement a program of 'opening up' and modernisation. Deng Xiaoping, the former leader of China and the policy's principal architect, emphasised the importance of law for economic

[669] ibid
[670] Wu (n667) 284.
[671] Behr, 'Development of a New Legal System in the People's Republic of China' (2007) 67 Louisiana Law Review 1161.
[672] Zhang, *Chinese Civil Law for Business* (Open University of Hong Kong Press 2013) 15.
[673] ibid
[674] Chen, 'The Transformation…' (n668).
[675] Zimmerman (n661) 35.
[676] Zhang (n665) 15.

development.[677] A modern legal regime was believed to ensure the institutionalisation of economic reform and engender confidence of the international community, therefore, it became one of the central elements of the opening up program in China.[678] Deng Xiaoping's famous paradigm of 'crossing the river by feeling its stones'[679] was used to implement the reform and break down resistance to it.[680] Although the Cultural Revolution left China with a legal, cultural and moral vacuum,[681] the process of legal reform was not embarked on by the regulators with an entirely blank slate.[682] Whilst being aware of China's own legal tradition, the regulators also recognised usefulness of foreign experience.[683] Development of the legal system over the following years was fuelled by the adoption of a socialist market economy 'with Chinese characteristics' in the early 1990s, which was further accelerated by China's accession to the World Trade Organisation (WTO) in 2001.[684]

4.2. China's Tradition of Legal Transplantation

As can be seen from Part 4.1 on historical development of China's legal system, legal transplantation has played a crucial role in the process of its reform that began in the late Qing period. During the first period of the PRC, the reforms relied on legal norms borrowed mostly from the Soviet Union,[685] however, once economic reforms initiated by Deng Xiaoping speeded up, China's regulators turned to the US, the UK and the Continental Europe for possible inspirations. The process of legal transplantation from these jurisdictions accelerated during the second decade of the reforms when a wider array of officials recognised that harmonisation of China's legal system with international standards and practice was indispensable for successful economic development. Moreover, involvement of international agencies such as the World Bank and the WTO played an important role in widening China's perspective on foreign models.[686] The old cohort of legal scholars and politicians educated in the Soviet Union that participated in drafting the laws was replaced by the new one educated in common law countries constituting yet another factor that influenced China's

[677] Chen, 'The Transformation…' (n668).
[678] Zimmerman (n661) 53.
[679] It generally means moving in a new direction by feeling the way forward in an incremental fashion, which in reference to law translates into the *ad hoc* and piecemeal approach.
[680] Lin (n7) 59.
[681] Zhang (n665) 8.
[682] Keller, 'Sources of Order in Chinese Law' (1994) 42 The American Journal of Comparative Law 711.
[683] Chen (n668) 706-7.
[684] ibid 706-10.
[685] ibid 704.
[686] ibid 712; Potter, *The Chinese Legal System: Globalization and Local Legal Culture* (RoutledgeCurzon 2001) 4.

laws.[687] Expected membership of the WTO and necessity to comply with its requirements greatly impacted new law-making and revision of existing laws to be in line with the WTO agreements and commitments.[688] Securities and company laws, as well as a range of other measures aimed at regulating China's domestic economy, undertook major revisions and presently often reflect norms and terminology drawn from Anglo-American traditions.[689]

Situation was no different in case of China's takeover regime, which was also developed through legal transplantation predominantly inspired by the US, the UK and Hong Kong takeover regulations.[690] The latter's influence on the Takeover Measures can be traced back to the early 1990s when Chinese government sought to raise foreign capital through Hong Kong, which created an opportunity for Hong Kong regulatory experts to guide China's relevant authorities to adopt certain laws and regulations similar to those established in Hong Kong.[691] Since the law of Hong Kong is itself heavily inspired by the UK's tradition,[692] many provisions of the Takeover Measures have been indirectly based on the UK's Takeover Code.

China's extensive use of legal transplants may partially be explained by a positive social attitude towards 'copying', which in China is part of traditional education which considers copying as something desirable and praised.[693] Moreover, the fact that during the drafting processes China relied on the expertise of foreign-educated Chinese and international scholars also explains omnipresent foreign influence on China's laws and regulations.

4.3. Legal and Institutional Framework

4.3.1. Legislative Bodies and Sources of Law

China's legal framework is embodied within the context of powers vested in the hands of various state organs. The National People's Congress (NPC) and its Standing Committee (NPC-SC) exercise the legislative power of the State under the PRC Constitution.[694] The NPC is responsible for enacting and amending basic laws governing criminal offences, civil affairs and other

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[687] Potter (n686).
[688] Wu (n667) 280.
[689] Art and Gu, 'China Incorporated: The First Corporation Law of the People's Republic of China' (1995) 20 The Yale Journal of International Law 273.
[690] Chen (n17) 3.
[691] Yu, 'Does One...' (n19) 50.
[692] ibid
[693] Behr (n671).
[694] Zhonghua Renmin Gongheguo Xianfa [Constitution of the People's Republic of China] promulgated by the NPC, 4 December 1982 (amended 2018) art 58 (Constitution).

matters of national application,[695] while the NPC-SC enacts and amends all laws except for basic laws.[696]

In terms of supremacy and precedence, the law sources can be listed as follows: the Constitution, laws at the national level (international treaties to which China is a party are parallel with the laws)[697], administrative regulations by the State Council, administrative rules by the State Council's ministries and commissions, local regulations issued by the people's congress on provincial and municipal level[698] and rules enacted by the government of a province.[699]

Since the law and politics remain closely connected in China, the policies of the CPC play an important role in the law-making process.[700] Although formally not legally binding, the Party's policies are sometimes considered by the courts when adjudicating cases.[701] As noted by Potter, various elements of local legal culture[702] also impact the reception of legal norms by individuals and groups in society and influence the way in which legal institutions operate in China.[703] For example, emphasis on social harmony discourages litigation and may explain the popularity of alternative dispute resolutions (ADR) in China.

The Supreme People's Court (SPC) and the Supreme People's Procuratorate (SPP), placed by the Chinese constitutional law theory within the state structures as a subset of the NPC and state administration,[704] both have a power to issue interpretations in the form of 'interpretation', 'provision', 'reply' and 'decision' on specific issues concerning the application of law in the trial work.[705] Pursuant to Article 5 the Provisions on the Judicial Interpretation Work [706] (SPC

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[695] Constitution, art 62(3).
[696] Constitution, art 67(2).
[697] Zhang, 'Pushing the Envelope: Application of Guiding Cases in Chinese Courts and Development of Case Law in China' (2017) 26 Washington International Law Journal Association 270 , 282.
[698] The legal authority between the rules issued by the State Council's departments and those issued by the local governments is the same and they are implemented within their respective scope of authority. The State Council stated that when the matter is of a regional nature, it is subject to regulation by local legislative power. The rules issued by the State Council will become applicable only to matters involving the national domestic market. Wu, 'The Making of a Market Economy in China : Transformation of Government Regulation of Market Development' (2007) 13 European Law Journal 750 , 768 ; Li and Otto, 'Central and Local Law-Making: Studying China's Experience' in Vermeer and d' Hooghe (eds), *China's Legal Reforms and Their Political Limits* (Curzon 2000) 20.
[699] Zhonghua Renmin Gongheguo Lifa Fa [Legislation Law of the People's Republic of China] promulgated by the NPC, 15 March 2000 (amended 2015) arts 87-92 (Legislation Law).
[700] Zhang (n697) 283.
[701] ibid 283.
[702] Defined as 'parts of general culture – customs, opinions, ways of doing and thinking – that bend social forces toward or away from the law and in particular way'; Friedman, *The Legal System: A Social Science Perspective* (Russell Sage Foundation 1975) 15.
[703] Potter (n686) 6-11.
[704] Keith and Lin, 'Judicial Interpretation of China's Supreme People's Court as "Secondary Law" with Special Reference to Criminal Law' (2009) 23 China Information 223.
[705] Zuigao Renmin Fayuan Guanyy Sifa Jieshi Gongzuo De Guiding [Provisions on the Judicial Interpretation Work] issued by the SPC, 09 March 2007, arts 2, 6 (SPC Provisions).
[706] SPC Provisions, art 5.

Provisions), judicial interpretations have force of law. Although whether or not judicial interpretations constitute source of law remains an unsettled issue in China,[707] their role in shaping China's legal system has been broadly recognised, in particular in relation to clarifying vague and ambiguous stipulations in law.[708]

4.3.2. The System of Guiding Cases[709]

In 2010 China formally established a system of guiding cases, which supplements and enriches statutory law.[710] The system's main objectives are to summarise adjudication experiences, unify the application of law and enhance adjudication quality and safeguard judicial impartiality.[711] It comprises cases representative of legal problems which shall be used as a reference by the lower courts deciding analogous cases. To create a guiding case the Judicial Committee of the SPC selects an already decided case that meets a set of certain requirements.[712] Any final judgment by either the SPC or any other court is suitable to become a guiding case as long as it is characterised as either being of widespread concern to society, involving legal provisions of relatively general nature; being of a typical nature or being difficult, complicated or of a new type.[713] Thus, creation of a guiding case constitutes a simple conversion process with no new adjudicative activity involved.[714]

The system of guiding cases was put on statutory footing in 2018 when the NPC recognised in the revised Organic Law of the People's Courts[715] (Courts Law)

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[707] Legislative power in China rests solely in the hands of the NPC and other authorised organs. If the specific meaning of a provision of law requires further clarification or a new situation arises after enactment of such law requiring clarification on its application, the power of interpretation of law belongs to the NPC-SC (Legislation Law, art 45). However, the NPC-SC authorised the SPC to provide interpretation if the issue arises involving specific application of law in court trials. For more detailed discussion see eg, Corne, 'Creation and Application of Law in the Prc' [The American Society of Comparative Law, Inc] 50 The American Journal of Comparative Law 369 (claiming that the SPC has been freely interpreting laws even without the present of lawsuits making the SPC almost exclusively a law interpreting authority); Cao, 'The Legal Status of Decisions and Judicial Interpretations of the Supreme Court of China' (2008) 3 Frontiers of Law in China 1 (arguing that some judicial interpretations should be treated as customary law and as such should constitute the source of law); Zhang (n694) 287 (suggesting that since the citation of judicial interpretations is required in judicial decisions, judicial interpretations should be deemed a source of law); Deng, 'The Guiding Case System in Mainland China' (2015) 10 Frontiers of Law in China 1 (arguing that judiciary does not have the authority to 'fill in gaps' in legislation because this role belongs exclusively to legislature).

[708] Keith and Lin (n704); Feng, 'The Future of Judicial Independence in China' (2016) 2 Centre for Judicial Education and Research CUHK, Working Paper Series.

[709] This chapter focuses solely on the SPC's work and does not further discuss the SPP's role in this area.

[710] Deng (n707) 7.

[711]Zuigao Renmin Fayuan Guanyu Anli Zhidao Gongzuo de Duiding [Provisions Concerning Work on Case Guidance] issued by the Adjudication Committee of the SPC, 26 November 2010 (Guiding Cases Provisions).

[712] Guiding Cases Provisions, art 4.

[713] Guiding Cases Provisions, art 2.

[714] Xingliang, 'China's Guiding Case System: A Study on the Mechanisms of Rule Formation' 1 Peking University Law Journal 215.

[715] Zhonghua Renmin Gongheguo Renmin Fayuan Zuzhi Fa [Organic Law of the People's Courts] promulgated by the NPC, 01 July 1979 (amended 2018) arts 18, 37 (Courts Law).

the SPC's authority to issue guiding cases. Although no provision of the Courts Law explicitly addresses the guiding cases' legal authority,[716] Article 37 appears to suggest that guiding cases have a guiding rather than a binding effect. This new development has brought some clarification to a frequently discussed issue of whether or not guiding cases have *de jure* binding force. Article 7 of the Provisions Concerning Work on Case Guidance (Guiding Cases Provisions)[717] issued in 2010 states that 'the courts at all levels shall refer to the guiding cases when adjudicating similar cases', but the meaning of shall 'refer to' has not been further defined. Article 10 of the Detailed Rules for the Implementation of the Provisions [718] (Detailed Rules) promulgated in 2015 stipulates that when referring to a guiding case, the court is required to 'cite the guiding case in its judgment reasoning, but may not use the guiding case as the legal basis for its judgment'. Opinion on Putting a Judicial Responsibility System in Place and Improving Mechanisms for Trial Oversight and Management[719] (Opinion on Mechanisms for Trial Oversight) issued in 2017 by the SPC provides for the establishment of a mechanism requiring the search of similar and relevant cases.[720] It, therefore, appears that 'to refer to' the guiding cases simply means to cite a relevant guiding case in the judgment reasoning, rather than 'to follow' and be bound by it.[721] Kui Chun[722] believes that 'to refer to' should be construed as 'to consult and follow' meaning that a guiding case should be used as a basis for supporting the reasoning phase of the adjudication work but cannot be cited as the basis for a decision. Linming Wang,[723] however, understands 'to refer to' as 'to follow' and as such considers the application of guiding cases compulsory – if there is a relevant guiding case the judge must follow the established precedent. It appears that the prevailing opinion regarding the guiding cases is that whilst not being *de jure* binding, the cases are *de facto* binding.[724]

The system of guiding cases was initiated as a possible remedy to the problem inherent in China's legal regime involving 'same case - different judgment'.[725]

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[716] Deng (n707).
[717] Guiding Cases Provisions.
[718] Detailed Rules for the Implementation of the Provisions, issued by the SPC, 13 May 2015.
[719] Putting a Judicial Responsibility System in Place and Improving Mechanisms for Trial Oversight and Management, issued by the SPC, 12 April 2017 (Opinions on Mechanisms for Trial Oversight).
[720] Opinion on Mechanisms for Trial Oversight, art 6.
[721] Zhang (n694) 299.
[722] Chen, 'How to Apply the Guiding Cases of the Supreme People's Court in Judicial Practice' China Guiding Cases Project (22 April 2012) <http://cgc.law.stanford.edu/commentaries/3-judge-chen> accessed 15 March 2018.
[723] Wang, Wogua Anli Zhidao Zhidu Ruogan Wenti Yanjiu [Some Issues on the Guiding Case System] (2012) 1 Faxue (Law Science) 71-80.
[724] Friedmann, 'Ip in China: Moving Closer to the Common Law System for the Sake of Uniformity' (2017) 12 Journal of Intellectual Property Law & Practice 621 621; Xingliang (n714) 628-629; Deng (n707) 6.
[725] See Part 4.5 for a detailed discussion.

Since guiding cases promote a persuasive precedential system, they provide some clarification regarding application of often very general statutes.[726] The system is also helpful in shifting the actual control over lower courts from the local authorities to the SPC and consolidating the independence of the judiciary as a whole.[727]

4.4. Rule of Law

One of the most heated discussions regarding China's contemporary legal system revolves around the concept of rule of law. Whilst it is possible to find the supporters of the opposing arguments on both extremes of the spectrum, whether or not China is a country with prevailing rule of law is not a straightforward issue. With an overall score of 0.48 (out of 1) measured using the Rule of Law Index,[728] China is placed on the 80th position in the global ranking of countries adhering to the rule of law.

The CPC is named as China's leading party by the Preamble of the country's Constitution. Although since 1979 China's leadership continues to emphasise the importance of the rule of law, the Party also insists on preserving its dominant role[729] in Chinese society.[730] One of the main attributes of the country with a strong rule of law is the ability of law to impose meaningful limits on the government and the state officials. Constraints on government power (factor 1), as measured by the Rule of Law Index, constitutes the weakest of all China's rule of law factors[731] placing China on the 104th position in the global ranking. While the Rule of Law Index recognises China's medium score (0.58 score) in the area evaluating the limit on government power in the fundamental law (sub-factor no 1)[732], the constraints produced by the judiciary (sub-factor no 2) with a score of 0.38 remain very low.

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[726] Deng (n707) 22-27; Chen, 'The Transformation…' (n668).

[727] Zhang, "Five-Year Review of China's Case Guidance System' (2016) Z Chin R 20, 23.

[728] The Rule of Law Index, developed by the World Justice Project, is a quantitative assessment tool created to provide a comprehensive picture of the extent to which countries adhere to the rule of law in practice. 'WJP Rule of Law Index 2016, China' <data.worldjusticeproject.org/#/groups/CHN> accessed 18 March 2017.

[729] The Party's behaviour is however constrained by the need to sustain economic growth and attract foreign investment, the rising discontent over corruption as well as growing domestic demand and pressure from international community to sustain the rule of law in China. Peerenboom (n12) 11.

[730] Lubman, 'Bird in a Cage: Chinese Law Reform after Twenty Years' (2000) 20 Northwestern Journal of International Law & Business 383.

[731] Other factors include absence of corruption, open government, fundamental rights, order and security, regulatory enforcement, civil justice, and criminal justice.

[732] Including provisions that prohibit constitutional amendments and suspensions of constitutional rights and privileges, except in accordance with the rules and procedures provided in the fundamental law itself. Botero and Ponce, 'Measuring the Rule of Law' < https://ssrn.com/abstract=1966257 > accessed 18 March 2019.

China scored relatively well on the first sub-factor possibly because the legislature has traditionally been influenced by the prerogatives of the Party,[733] therefore, the law, whilst formally constraining the power of the state officials is, at the same time, drafted in a way to give them a relatively broad span of discretionary authority. The provisions of law are written in a rather vague and ambiguous way which makes it easy for the government to appear to follow the rules and act within the letter of law.[734] Chinese laws and regulations are intended to be instruments of policy enforcement enacted explicitly to achieve the policy objectives of the government, instead of being an expression of unchallengeable general norms applied consistently in a variety of situations.[735] Peerenboom points out that every country uses law instrumentally, yet two types of instrumentalism can be distinguished: acceptable instrumentalism (rule of law) and pernicious instrumentalism (rule by law),[736] with China being often considered a country with the latter.[737] The move from a pure instrumentalist conception of law towards the rule of law has, however, been observed with the law gradually narrowing the discretion of the Party.[738] The process nevertheless remains rather slow and China still diverges significantly from the Western conception of rule of law.[739] The sluggishness of the transformation has its roots in, among other factors, the fashion in which China has been adopting new regulations since the start of its economic reform. New measures are often issued in an incremental and *ex-post* mode, after administrative measures had first been used as trials within limited spheres. The nationwide regulations are usually adopted only after the experimental measures prove to be a success.[740]

The major reason why China scored poorly on the second sub-factor (constraints produced by the judiciary) may be insufficient judicial competence and independence. Independence of the judiciary is often considered a pillar of the rule of law[741] and an element indispensable for adequately constraining the state. Although the Constitution provides for judicial independence,[742] the scope

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[733] Potter (n686) 17.
[734] ibid 24.
[735] ibid 10.
[736] Peerenboom (n12) 23.
[737] Liang, *The Changing Chinese Legal System, 1978–Present: Centralization of Power and Rationalization of the Legal System* (Routledge 2007) 68 ; Peerenboom (n12) 8, 23.
[738] Potter (n686) 8-10.
[739] Peerenboom (n12); Chen, ' The Transformation…' (n668) 713; Liang (n737) 69.
[740] Wu, 'The Making of a Market Economy in China : Transformation of Government Regulation of Market Development' 770.
[741] International Association of Judicial Independence and World Peace, 'Mt Scopus Approved Revised International Standards of Judicial Independence' (International Project of Judicial Independence, 2012) <www.jiwp.org/mt-scopus-standards.> accessed 18 January 2019.
[742] Out of six components of *de jure* independence, namely: statement of judicial independence; judicial tenure; selection procedure; removal procedure; limited removal conditions; and salary insulation, the Chinese Constitution only provides for the statement of independence. Feng, 'The Future of Judicial

thereof is limited to a basic statement of independence. More comprehensive protection of judicial independence has been provided in the Judges Law of the PRC, thus the notion that China is a country with at least some *de jure* judicial independence is generally accepted.[743] *De facto* judicial independence attracts more scholarly attention as certain mechanisms and circumstances under which the courts operate in China inevitably compromise judicial independence. Firstly, the SPC and China's judiciary are not a separate branch of the state in the sense that the US and UK's judiciaries are separate from the executive and legislative branches under the traditional 'separation of powers' doctrine. Instead, the bureaucracy headed by the SPC is under the legislature (the NPC), just as the top of executive government (the State Council) is formally subordinate to the NPC.[744] The CPC's extensive influence over the operations of China's court system, especially in relation to adjudication and enforcement of certain cases, is exercised through the system of 'political-legal committees'.[745] Moreover, the Party can ensure an appropriate and 'correct' judgment in some major, complicated, controversial or sensitive cases through separate 'adjudication committees'[746] present in each court which decide upon the application of law in such cases, even those already tried by other judges.[747] Moreover, since local governments are the main source of the courts' funding at the corresponding level, they are often able to impose pressure upon the judges.[748] Similarly, the appointment of judges also remains problematic because the Party's departments and local governments control the process of nomination of judges at the local level.[749] Both mechanisms result in local protectionism. The situation is likely to improve in the future as a result of implementation of one of the key reforms contemplated in the Whitepaper on Judicial Reform of Chinese Courts[750] (SPC Whitepaper) issued in 2016, which

Independence in China' in Lee and Pittard (eds), *Asia-Pacific Judiciaries: Independence, Impartiality and Integrity* (Cambridge University Press 2018) 87-88.

[743] ibid (nevertheless calling for reform to enhance constitutional protection of judicial independence).

[744] See Part 4.3.1 on China's legislative bodies and sources of law.

[745] Chen, 'Out of the Shadows and Back to the Future : Cpc and Law in China China' (2017) [Routledge] 24 Asia Pacific Law Review 176 194-200; Clarke, 'Power and Politics in the Chinese Court System: The Enforcement of Civil Judgments' (1996) 10 Columbia Journal of Asian Law 1, 50; Jia, 'Chinese Common Law? Guiding Cases and Judicial Reform' (2016) 129 Harvard Law Review 2213 , 2216-7.

[746] A body composed of officials with the highest administrative rankings in a court. Often appointed simply because they are members of the Party's leadership who happen to be *de facto* court leaders. Being portrayed as experts, the committees, professionally direct consistent and principled adjudication and enforcement. He, 'Black Hole of Responsibility: The Adjudication Committee's Role in a Chinese Court' (2012) 46 Law & Society Review 681, 686-7.

[747] ibid 682; Clarke (n745) 12-13.

[748] Clarke (n745) 48; Feng, 'The Future...' (n742) 96.

[749] Peerenboom (n12) 83.

[750] The SPC, 'Whitepaper on Judicial Reform in China' (29 February 2016) <http://english.court.gov.cn/2016-03/03/content_23724636.htm> (SPC Whitepaper 2016).

envisages pushing forward the unified management of personnel and funds of local courts from local to the provincial level.

Jianfu Chen raises an argument that the rule of law is a Western concept and as such should not be used to evaluate advancement of China's legal development.[751] Chen suggests that the term 'ruling the country according to law' is more appropriate in China's case because it originates from the country's domestic environment, claiming, that when the rule of law in China is measured based on the criteria derived from the Chinese context its development in China appears to be reasonably positive and promising. One must also note that law in China is becoming more responsive to social pressures. The process of law-making has gradually become more transparent, as drafts of laws and regulations became subject to public consultation.[752]

4.5. 'Same Case - Different Judgment' Problem

Whilst the rule of law requires that 'laws be applied equally, without unjustifiable differentiation', [753] China's legal regime has long been characterised by 'same case - different judgment' phenomenon.[754] One of the principles of Chinese legislative drafting is 'generality' and 'flexibility' of its primary laws, which tend to concentrate on principles and broader goals[755] often resulting in the statutes being unclear and ambiguous.[756] Ministries and lower legislative agencies are provided with the power to elaborate the specifics through regulations.[757] This practice affords flexibility by allowing laws to be adopted to changing circumstances,[758] but the lack of mechanisms to effectively limit lower-level agencies' discretion can undermine the original legislative intent and lead to inconsistent application of the law by the judges in China.[759] It is, however, sometimes argued that the lack of clear and unambiguous laws is not the primary concern because the problem of inconsistent application of law is rooted mainly in judicial corruption and various restraints placed on judicial authority.[760] Moreover, additional issues such as unequal quality of the judges,

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[751] Chen, 'The Transformation…' (n668) 729-33.
[752] Peerenboom (n12) 240-3; Chen, 'The Transformation…' (n668) 731.
[753] Steyn, 'Consistency–a Principle of Public Law?' (1997) 2 Judicial Review 22, 22.
[754] Deng (n707) 6; Peerenboom (n12) 478-495.
[755] OECD, 'Reviews of Regulatory Reform: China 2009' < https://www.oecd.org/china/42390089.pdf> accessed 4 April 2018; Peerenboom (n12) 251.
[756] ibid 251; Keller (n679) 745.
[757] Peerenboom (n12) 251; 'Reviews of Regulatory Reform' (n755).
[758] 'Reviews of Regulatory Reform' (n755).
[759] Deng (n707) 6.
[760] Xingliang (n714).

heavy workload of the courts and an imbalanced development of different regions further add to discrepancies between judgements.[761]

4.6. The Role of the Party in Corporate Governance

In China, apart from the major players traditionally found in the Anglo-American corporate governance model, a number of other actors are involved in the corporate governance of listed companies with the CPC being the most influential one.[762] While direct administrative channels of control do not seem to exist anymore, they often continue to play a 'behind the scenes' role, undermining formal legal provisions contained in the Company Law and other relevant regulations.[763]

Being converted from the traditional SOEs, many companies listed on China's stock exchanges experience political control. Some of them are directly managed by the state through concentrated ownership.[764] Moreover, similarly to all other spheres of socio-economic life in China, the CPC exercises its power in the corporate setting through the 'nomenklatura' system.[765] Nomenklatura allows the Party to have a dominant say over personnel decisions of important positions in the SOEs by making appointments, promotions and dismissals of the company's top cadres.[766] Consequently, Chinese companies are often dominated by insiders with political power which substantially surpasses their formal authority.[767] When discussing China's corporate governance, Wang refers to the 'grabbing hand', suggesting that even modern SOEs are nowadays used to serve political and social objectives, which negatively affects their financial performance.[768]

Despite various reforms aimed at market liberalisation, the Party's influence over SOEs has been increasing in recent years. In 2016, at the Conference on Building the Role of the CPC within SOEs, Xi Jinping emphasised that SOEs are the foundation of 'socialism with Chinese characteristics' and, therefore, upholding the Party's leadership over SOEs is one of the major political

[761] Deng (n707) 3-4.
[762] Wang, 'Corporate Governance in China: The Law and Its Political Logic' in Tomasic (ed), *Routledge Handbook of Corporate Law* (Routledge 2016) 193-221.
[763] Howson, '" Quack Corporate Governance" as Traditional Chinese Medicine: The Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle against Party State Political Economic Power' (2014) 37 Seattle University Law Review 667.
[764] Wang, 'Corporate Governance...' (n762) 193-221; see pages 152 - 153 for more detailed description of the system of state's corporate ownership.
[765] ibid
[766] ibid
[767] Howson and Clarke, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China' in Puchniak, Baum and Ewing-Chow (eds), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012)
[768] Wang, 'Corporate Governance...' (n762) 193-221.

principles.[769] The Party, embedded into firms' corporate governance structure, should play a major role in their policymaking, implementation and monitoring, whilst the top managers and directors of state firms must remain loyal to the CPC.[770] In 2017 the 19th National Congress of the CPC officially approved the addition of 'Xi Jinping's Thought on Socialism with Chinese Characteristics for a New Era' into the Party's Constitution.[771]

Whilst privately owned listed companies are also often politically influenced via party-organisations established within them, direct impact on decision-making and personnel appointment exists to a generally lesser degree than in case of SOEs.[772] However, in light of the recent security incident involving Huawei,[773] one of the world's largest telecoms companies, more attention has been given to the transparency of the ownership structure of some of the leading Chinese private companies. For example, after having scrupulously analysed Huawei's corporate structure, Balding and Clarke[774] concluded that although Huawei is officially wholly-owned by its employees, the employees have no governance or control rights over Huawei and it remains unclear as to who exactly controls the company.[775] Whilst Huawei's case certainly does not reflect the situation in all privately owned firms, it provides a cautionary tale on transparency of their ownership structure and validity of official shareholding records.

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[769] Xijinping Zai Guanguo Guoyou Qiye Dang de Jianshe Gongzuo Huiyi Shang Qiangdiao: Jianchi Dang Dui Guoqi de Lingdao Bu Dongyao [Xi Jinping Emphasises the Party's Leadership in the SOEs at the Conference on Building the Role of the CPC within the SOEs] *Xinhuanet* (11 Oct 2016) < www.xinhuanet.com/politics/2016-10/11/c_1119697415.htm > accessed 10 July 2018.
[770] ibid
[771] 'Resolution of the 19th National Congress of the CPC Central Committee on the Report of the 18th Central Committee' *Xinhuanet* (24 October 2017) ≥ accessed 12 July 2018.
[772] Wang, 'Corporate Governance...' (n762).
[773] See eg O'Flaherty 'Huawei Security Scandal: Everything You Need to Know' *Forbs* (26 February 2019)< https://www.forbes.com/sites/kateoflahertyuk/2019/02/26/huawei-security-scandal-everything-you-need-to-know/#3489f02d73a5> accessed 18 April 2019.
[774] Balding and Clarke, 'Who Owns Huawei?' (17 April 2019) <papers.ssrn.com/sol3/papers.cfm?abstract_id=3372669&download=yes> accessed 18 April 2019.
[775] For Huawei's response see Bicheno, 'Huawei Responds to Study Questioning who Really Owns It' (Telecoms. com, 18 April 2019) <http://telecoms.com/496982/huawei-responds-to-study-questioning-who-really-owns-it/> accessed 18 April 2019.

CHAPTER V China's Takeover Regulations

5.1. Regulatory and Institutional Framework

The current legal framework for the regulation of takeover activities in China consists of general laws, administrative regulations and rules, judicial interpretations, guiding cases and self-regulatory guidelines. The Company Law of the People's Republic of China [776] (Company Law) and the Securities Law of the People's Republic of China[777] (Securities Law) provide a general framework for corporate control transactions, but do not contain a complete set of regulations governing mergers and acquisitions of listed firms. Detailed takeover rules are contained in the Measures for the Administration of the Takeover of Listed Companies [778] (Takeover Measures) adopted by the China Securities Regulatory Commission (CSRC). Some issues relevant to M&As are covered by the Anti-Monopoly Law of the People's Republic of China[779] (AML), Measures for the Administration of the Material Asset Restructurings of Listed Companies,[780] and Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors (Provisions on Foreign Investors Acquisitions).[781] Takeover transactions are further governed by self-regulatory rules of the Shanghai and Shenzhen stock exchanges. Some relevant issues such as selected shareholders' rights, issuance of new shares and procedural aspects of derivative claims have been addressed by the SPC's judicial interpretations.

The conduct of the target board of directors and its duties in the context of change of corporate control transactions are further governed by the firms' articles of association (AAs). Although the Company Law provides default provisions on the scope of power and the duties of shareholders, directors and supervisors,[782] the shareholders are free to alter the discretionary provisions of the statute[783] in the company's articles with respect to some matters related to corporate governance.[784]

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[776] Zhonghua Renmin Gongheguo Gongsi Fa [Company Law of the People's Republic of China] promulgated by the NPC, 29 December 1993 (amended 2018) (CL).

[777] Zhonghua Renmín Gongheguo Zhengquan Fa [Securities Law of the People's Republic of China] promulgated by the NPC, 29 December 1998 (amended 2014) (SL).

[778] TM (n9).

[779] Zhonghua Renmin Gongheguo Fan Longduan Fa [Anti-Monopoly Law of the People's Republic of China] promulgated by the NPC, 30 August 2007 (AML).

[780] Shangshi Gongsi Zhongda Zichan Chongzu Guanli Banfa [Measures for the Administration of the Material Asset Restructurings of Listed Companies] promulgated by the CSRC, 2014 (amended 2016) (Measures for Asset Restructurings).

[781] Guanyu Waiguo Touzi Zhe Binggou Jingnei Qiye De Guiding [Provisions on the Merger and Acquisition of Domestic Enterprises by Foreign Investors] promulgated by MOFCOM, 2009.

[782] CL, arts 98-119.

[783] Eg CL, arts 104, 105 and 108.

[784] Dickinson, 'Introduction to the New Company Law of the People's Republic of China' (2007) 16 Pacific Rim Law & Policy Journal 1, 2.

With regard to the institutional framework, the highest decision-making agency for takeover regulations is the State Council. The second level authority includes the core ministry-level agencies: the CSRC, which has the main regulatory and supervisory function over the securities markets in China and the State Administration for Market Regulation (SAMR) responsible for merger control[785]. Moreover, certain functional departments responsible for specific fields such as finance and taxation and authorities supervising particular sectors such as banking and agriculture play consultative roles. Change of control transactions by means of a share purchase agreement or a tender offer are further supervised by the national exchanges on which the companies' shares are traded. On top of that, transactions involving SOEs are administrated and supervised by State-Owned Assets Supervision and Administration Commission (SASAC).

The securities market principal regulator, the CSRC is responsible for supervising takeovers and enforcing the Takeover Measures.[786] A separate M&A Review Committee composed of 40 members, of which the CSRC's representatives should not be more than 11,[787] reviews the documents submitted by the parties to a takeover transaction.[788] Apart from the CSRC members, the M&A Review Committee comprises stock exchange committee members, lawyers, accountants, asset appraisers, members of securities companies and expert scholars.[789] Unlike the UK, where the Panel is an independent body, the M&A Review Committee in China is an internal organ of the CSRC[790] and its members are expected to have 'high political thinking and quality'[791]. The CSRC is entitled to establish an *ad hoc* M&A Expert Advisory Committee composed of professionals and experts in the field from both the CSRC and outside[792] to

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[785] Shichang Jianguan Zongju Guanyu Fan Longduan Zhifa Shouquan De Tongzhi [Notice of the State Administration for Market Regulation on the Empowerment of Anti-monopoly Law Enforcement] promulgated by the SAMR, 28 December 2018.
[786] TM, art 10.
[787] Shangshi Gongsi Binggou Chongzu Shenhe Weiyuanhui Gongzuu Guicheng [Working Rules of the Review Committee for the Merger, Acquisition and Restructuring of Listed Companies] promulgated by the CSRC, 17 July 2007 (Revised 2018) art 5 (Working Rules of M&A Review Committee).
[788] Working Rules on M&A Review Committee, arts 2-3.
[789] For example, the 4th M&A Review Committee consisted of seven CSRC members, two stock exchange committee members, six lawyers, six accountants, six asset appraisers, six members of securities companies and two expert scholars. Before the revision to the Working Rules on M&A Review Committee in 2018 that expanded the Committee to 40 members, it was composed of 35 members. See 'Zhengjian Hui Pinren Xin Yi Jie Binggou Chongzu Wei, Zhuanjia Zixun Wei Weiyuan' [The CSRC Appointed New Members of the M&A Review Committee and Expert Advisory Committee] *China.com.cn* (4 May 2012) <www.china.com.cn/policy/txt/2012-05/04/content_25300898.htm> accessed 10 January 2018.
[790] Chen (n17).
[791] Working Rules of M&A Review Committee, art 8.
[792] Maximum of 35 members. [Shangshi Gongsi Binggou Chongzu Zhuanjia Zīxun Weiyuanhui Gongzuo Guize [Working Rules of Expert Advisory Committee for the Merger, Acquisition and Restructuring of Listed Companies] promulgated by the CSRC, 6 February 2012, art 3 (Working Rules of M&A Expert Committee).

provide consultative opinions on M&A related issues.[793] The M&A Expert Advisory Committee is responsible for advising on difficult issues related to takeovers and providing guidance regarding legal and accounting concerns.[794] The Committee's opinions are not binding and the CSRC is responsible for making final decisions.[795]

Although since 2014 there is no requirement to obtain an *ex-ante* approval of takeover transactions from the CSRC,[796] there still may be other regulatory stakeholders in the takeover approval process. The business of the acquirer and the target company, the industry and location of the target, the size of the transaction, the ownership of the target and other factors all affect the nature and complexity of the review and the authorities involved in the process. Deals above a certain threshold[797] must be approved by the SAMR before they can be completed.[798] A special approval may also be necessary if an acquisition is conducted by a foreign investor.[799] Where a transaction involves an SOE, an approval from the SASAC may be required.[800] Change of control transactions involving securities companies, commercial banks, insurance companies or internet service providers may be subject to additional approval by the relevant industrial regulatory authority.[801]

5.2. The Objectives of Takeover Regulations

As stated in the Takeover Measures, the aim of takeover regulations in China is to protect the lawful rights and interests of listed companies and their shareholders, maintain the order of the securities market and public interests as well as to promote the optimal allocation of resources.[802]

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[793] TM, art 10.
[794] Working Rules of M&A Expert Committee, art 2.
[795] TM, art 10.
[796] Guanyu Xiugai "Shangshi Gongsi Shougou Guanli Banfa" de Jueding [Decisions on Amending Measures for Regulating Takeovers of Listed Companies] issued by the CSRC, 23 October 2014 (TM Amendment Decision).
[797] Notification is needed when: the nationwide turnover within China of each of at least two of the undertakings concerned in the preceding year is more than RMB400 million (approximately GBP40 million), and either (1) the combined worldwide turnover of all the undertakings concerned in the proceeding financial year exceeds RMB10 billion (approximately GBP1 billion), or (2) the combined nationwide turnover within China of all the undertakings concerned is more than RMB2 billion (approximately GBP200 million) and at least RMB400 million separately. Guiding Opinions on Concentration Declaration, art 2.
[798] AML, art 21.
[799] TM, art 4; AML, art 31; Zhonghua Renmin Gongheguo Waishang Touzi Fa [Foreign Investment Law of the People's Republic of China] promulgated by the NPC, 15 March 2019, arts 2(2), 33 and 35.
[800] TM, art 4; Guowuyuan Bangong Ting Zhuanfa Guozi Wei Guanyu Tuijin Guoyou Ziben Tiaozheng He Guoyou Qiye Chongzu Zhidao Yijian De Tongzhi [Circular on Promoting the Adjustment of State-owned Capital and the Reorganization of State-owned Enterprises] issued by the General Office of the State Council, 12 May 2006, ss15-17.
[801] TM, art 4.
[802] TM, art 1.

The outline of the public policy on the role of takeovers was set out by the State Council in its Opinions on Promoting Corporate Mergers and Restructuring[803] (Merger and Restructuring Opinions) issued in 2010. Takeovers are seen as means to accelerate economic development through restructuring activities, the promotion of growth of Chinese companies and better allocation of resources. Moreover, change of control transactions are also considered a mechanism that helps to improve corporate governance of listed companies by allowing replacement of their management.[804] Therefore, in the opinion of the State Council, takeovers should be promoted in China. Detailed action plan aimed at facilitating such activities includes removing regulatory barriers that hinder takeover activities, implementing better tax incentives and encouraging commercial banks to expand the availability and scale of acquisition financing.[805]

5.3. Historical Background

China's modernisation and liberalisation policy initiated in the late 1970s emphasised the importance and need for improved efficiency of domestic companies, particularly those state-owned.[806] Development of securities markets in the 1980s became not just a part, but one of the priorities of the broader economic reform.[807] Among the main three goals that the policymakers aimed to achieve through capital markets was disciplining listed companies and promoting good corporate governance.[808]

Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) were established in 1990 and 1991 correspondingly creating the foundation of China's capital markets, which have been developed in a controlled manner.[809] The direction of the reform of China's economic system towards the market economy was firmly established in 1992, making mergers and acquisitions an essential part of the SOEs' reorganisation policy.[810] The first attempt to create a takeover regime in China was undertaken by the State Council which, in 1993, promulgated the Interim Provisions on the Administration of the Issuing and

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[803] Guowuyuan Guanyu Cujin Qiye Jiannbing Chongzu De Yijian [Opinions on Promoting Corporate Mergers and Restructuring] issued by the State Council, 25 August 2010 (Merger and Restructuring Opinions).
[804] Merger and Restructuring Opinions, s 2(a).
[805] ibid
[806] Torbert, 'China's Evolving Company Legislation: A Status Report' (1993) 14 Northwestern Journal of International Law & Business 1.
[807] ibid
[808] Wei, *Securities Markets and Corporate Governance: A Chinese Experience* (Routledge 2016).
[809] Shi, *The Political Determinants of Corporate Governance in China* (Routledge 2012) 46.
[810] OECD, 'The Theory of the Market for Corporate Control and the Current State of the Market for Corporate Control in China' <http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/31601011.pdf> accessed 10 March 2018.

Trading of Shares[811] (Issuing and Trading Shares Provisions) that contained provisions regulating disclosure, takeover offers and competitive bids.[812] Deals involving SOEs become prevalent during this early phase of the takeover market in China.[813]

The Company Law enacted in 1993 established a comprehensive framework for the reform of 'corporatisation' which sought to implement a 'modern enterprise system' to China by, e.g., converting SOEs into a legal form of 'corporations'.[814] Corporatisation did not equal privatisation, as the state retained the controlling stake in SOEs while allowing them to adopt the corporate form instituting stock ownership.[815] Through sale of minority interest in such corporations, the state was able to draw private capital into SOEs without compromising the ultimate control.[816] The policy of corporatisation was also designed to help SOEs, persistently suffering from losses caused by inefficiency and low productivity, to improve their financial performance.[817]

The 'grasp the large, release the small' policy was announced in 1997, the objective of which was to further decentralise and reform state corporations,[818] through facilitation of takeovers and restructuring of small and medium-sized SOEs. It was anticipated that inefficient and loss-making SOEs would be squeezed out by foreign competition after China's access to the WTO in 2001, therefore local governments often decided to dispose of those firms beforehand and, consequently, they took an active role in promoting takeover transactions.[819] The Securities Law was enacted in 1998 to facilitate and govern securities transactions. As a result, China's integration into the world economy was marked by a noticeable growth in M&A activities.

In order to establish a more comprehensive takeover regime, in 2002 the CSRC adopted Measures for Regulation Information Disclosure of the Changes in Shareholding of Listed Companies as well as the original version of the Takeover Measures, which were often heavily criticised.[820] Despite regulatory

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811 Gupiao Faxing Yu Jiaoyi Guanli Zhanxing Tiaoli [Interim Provisions on the Administration of the Issuing and Trading of Shares] promulgated by the State Council, 22 April 1993 (Issuing and Trading Shares Provisions), art 48(1).
812 Cai, 'The Mandatory Bid Rule in China' (2011) 12 European Business Organization Law Review 653.
813 'The Theory of the Market for Corporate Control'
814 Howson (n763); Wang, *Company Law…* (n4) 3-8.
815 Art and Gu (n689) 283.
816 ibid 283.
817 ibid 277.
818 Leng, *Corporate Governance and Financial Reform in China's Transition Economy* (Hong Kong University Press 2009) 63-115.
819 Weinreich-Zhao, *Chinese Merger Control Law. An Assessment of Its Competition-Policy Orientation after the First Years of Application* (Springer 2015).
820 Huang, 'China's Takeover Law: A Comparative Analysis and Proposals for Reform' (2005) 30 Delaware Journal of Corporate Law 145 156.

efforts, development of the market for corporate control was restricted due to the highly concentrated ownership structure of listed firms and the existence of non-tradeable shares, which were excluded from the market.[821] As a result, although the number of domestic M&A transactions recorded in 2002 alone reached 653 with a total transaction value of RMB 53.25 billion,[822] the number of takeovers by tender offer remained extremely limited. At that time takeovers were made mostly by agreement,[823] as non-tradeable shares restricted transactions through the stock market.[824] The introduction of the Split Share Structure Reform (SSS Reform) in 2005, in which non-tradeable shares have been gradually transformed into tradable shares, completely changed China's capital markets. In the following years, a competitive legal and regulatory infrastructure has been set up to reflect this change, to attract foreign capital and increase efficient allocation of resources.[825] The Company Law was almost entirely revised in 2005 introducing fiduciary duties of directors to China's corporate regime for the first time. A series of implemented changes indicated a move towards a market-based approach, in which state intervention in takeovers has been gradually lessened by the CSRC. The Takeover Measures promulgated in 2006 have effectively replaced the two mentioned earlier takeover-related regulations enacted in 2002.[826] Later that year newly issued Provisions for the Acquisition of Domestic Enterprises by Foreign Investors (M&A Provisions) replaced the Tentative M&A Provisions.

Thanks to the rapid growth of China's economy and modernisation of regulations governing its capital markets, the number of takeovers has increased substantially in China over the past several years.[827] Development of acquisitions via tender offer was nevertheless hampered by the lack of financing available to the potential acquirers,[828] but once the prohibition on acquisition financing imposed on commercial banks has been abolished,[829] the number of takeovers experienced yet another rise.[830] Nowadays, with 85% of tradeable

[821] Yang, Chi and Young (n5) 17.
[822] Weinreich-Zhao (n819).
[823] Yu, 'Using Western Law to Improve China's State-Owned Enterprises: Of Takeovers and Securities Fraud' (2004) 39 Valparaiso University Law Review 339.
[824] Yang, Chi and Young (n5) 17.
[825] Huang, 'The New Takeover Regulation in China: Evolution an Enhancement' 42 International Lawyer 153.
[826] Cai, 'The Mandatory...' (n812) 656.
[827] Tang and Metwalli, 'M&a in Greater China: An Update' 23 Journal of Corporate Accounting & Finance 27, 30.
[828] Banks in China were prohibited from giving loans to finance such transactions.
[829] Banks are now allowed to finance up to 50% of a takeover deal.
[830] Cai, 'Hostile Takeovers...' (n10).

shares[831] thanks to the SSS reform, China's capital markets present a very different landscape in comparison to when takeover activities were regulated for the first time. One must however note that, as Yao Gang, a former Vice Chairman of the CSRC, once said during the Symposium on Securities Investors Protection held in 2009: 'China's securities market is still an emerging and transitional market' with deficient regulatory mechanisms, immature and unsophisticated investors and unusual shareholding structures.[832] With such a background, hostile takeovers, although allowed by law, nevertheless remain a rare phenomenon and the vast majority of takeovers are still made by agreement.[833]

5.4. Basic Principles of Company Law Relevant to Defensive Responses to Hostile Takeovers

With extensive control rights allocated by the Company Law, the shareholders' meeting is the company's 'organ of power',[834] leaving the board of directors with a relatively narrow range of authority. Apart from electing and changing the directors and supervisors, as well as determining matters concerning their remuneration, the shareholders decide the company's operational policies and investment plans.[835] The shareholders also vote on matters such as merger, division, liquidation and amendment of the articles of association.[836] It is not clear under the statute who is responsible for proposing the articles' amendments, a provision giving the board power to formulate the proposals can be included in company's constitutional documents.[837]

It is typically the board that proposes and formulates issues to be voted on at the general meeting, although shareholders holding at least 3% of the company's shares have the right to propose resolutions to be decided at the meeting.[838] Article 102 of the Company Law provides that the proposal of a resolution must 'fall within the purview of the general meeting and shall have clear discussion points and matters to be decided'.[839] It is not clear who decides whether any

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[831] In 2014 total free-float market cap reached RMB31.56 trillion and represented 84.72% of the total market capitalisation. The CSRC, '2014 Annual Report' <http://www.csrc.gov.cn/pub/csrc_en/about/annual/201506/P020150612564204379767.pdf> accessed 18 April 2017.
[832] Fu, *Corporate Disclosure and Corporate Governance in China* (Kluwer Law International 2010) 12.
[833] Wang, *Company Law…* (n4).
[834] CL, art 98.
[835] CL, arts 37, 99.
[836] ibid
[837] It is a relatively common practice in China. See eg, China Vanke's articles at <https://www.vanke.com/en/upload/file/2016-05-12/02acd51e-ea0f-46f2-8168-d04c97f3c34f.pdf> accessed 10 October 2016.
[838] CL, art 102.
[839] ibid

given proposal fulfils the Article 102 requirement, which gives the board some scope to sabotage shareholders' proposal rights. In practice, the proposals are largely submitted by the controlling shareholders and they often receive more than 95% support at the general meeting.[840] Shareholders who individually or collectively hold at least 10% of company's shares have the right to call for a special meeting,[841] and the board of directors should convene the meeting at their request. If the board does not convene the meeting in a timely manner, shareholders individually or collectively holding at least 10% of the company's shares may convene and chair the meeting themselves.[842]

5.4.1. Election and Removal of Directors

Although the shareholders are granted statutory right to elect the company's directors,[843] the rules regulating the process of board appointment should be stipulated in the company's articles.[844] Article 18 of the Code of Corporate Governance for Listed Companies in China[845] (Governance Code) provides that transparent nomination and election procedures should ensure the openness, fairness and impartiality of directors' election. A nomination committee responsible for formulating standards and procedures for the election of directors, seeking and reviewing the qualified candidates and making recommendations may be established.[846] Although the nomination rights are not explicitly provided, qualified shareholders can nominate their candidate to the board by exercising the statutory proposal rights.[847] The boards in China are often dominated by insiders, such as founders and representatives of major investors,[848] which is not surprising since the majority of China's listed companies have a controlling shareholder that can easily nominate and elect its own candidates.

Article 105 of the Company Law allows the companies to adopt cumulative voting for directors' elections. Whilst the cumulative voting does not appear to

[840] Institutional Shareholder Services, 'China: Investor Stewardship. An Examination of Voting and Engagement Activities in China' (03 November 2014) <https://www.issgovernance.com/file/publications/china-investor-stewardship.pdf> accessed 16 May 2018.
[841] CL, art 100.
[842] CL, art 101.
[843] CL, arts 37, 99, 105.
[844] Shangshi Gongsi Zhangcheng Zhiyin [Guidelines of Articles of Association of Listed Companies] adopted by the CSRC, (Amended 2016) art 82 (AA's Guidelines),
[845] Shangshi Gongsi Zhili Zhunze [Code of Corporate Governance for Listed Companies in China] adopted by the CSRC, 30 September 2018 (China's CGC).
[846] China's CGC, arts 38, 41.
[847] See page 107.
[848] Huyghebaert and Wang, 'Expropriation of Minority Investors in Chinese Listed Firms: The Role of Internal and External Corporate Governance Mechanisms' (2012) 20 Corporate Governance: An International Review 308.

be mandatory under the statute, Article 17 of the Governance Code provides that a listed company with a controlling shareholder(s) holding more than 30% of the outstanding shares is required to adopt a cumulative voting system in order to fully reflect the opinions and interests of minority shareholders.

Shareholders in China are also entitled to remove the company's directors.[849] Article 146 of the Company Law provides for contingencies when a director must be removed (e.g., when his or her conduct violates laws and regulations). It does not, however, addresses the issue of removing board members without cause. The first version of the Company Law enacted in 1993 explicitly prohibited dismissal of directors without cause,[850] but the provision was deleted in 2005 when the Company Law was amended for the third time. The deletion of the prohibition may imply that it is now legitimate for shareholders to remove the company's directors simply because they are not satisfied with their conduct.

In a decision issued by one of China's local courts in 2010,[851] the judge held that a director can only be dismissed under one of the circumstances outlined by Article 146 and that shareholders are not allowed to remove directors in the events other than those specified by the Article. The appeal court upheld the decision, stating that there was no legal ground for the claim that the shareholders are equipped with the right to remove a director without cause. Liya Chen argues that this decision violates legal principles of the Company Law, claiming that it is completely in the discretion of the general meeting to dismiss any director, even without cause.[852] According to Jiangyu Wang, the prevailing opinion is that the lawmakers decided to leave the issue to the company's discretion which can choose itself (and articulate such a choice in its articles) whether or not to prohibit the dismissal of a director without cause.[853]

The issue has indirectly been addressed by the SPC in the guiding case issued in 2012[854] in which the court stated that the Company Law respects 'corporate autonomy' and the courts should not intervene in company's affairs as long as they do not violate the Company Law's mandatory provisions, other laws and regulations and the company's articles. In light of this, it appears that if an issue is not addressed in the Company Law it is up to the individual company to decide

[849] CL, arts 37(2), 99.
[850] Zhonghua Renmin Gongheguo Gongsi Fa [Company Law of the People's Republic of China] promulgated by the NPC, 29 December 1993, art 115 ('The shareholders meeting may not without reason remove a director from office before the term of office of the director expires').
[851] The case was described in Chen, 'Shareholder Right to Dismiss Directors' (20 March 2018) <debund.com/info/6d1e993784944b4da156f0423f1caf04> accessed 10 April 2018.
[852] ibid
[853] Wang, *Company Law…* (n4) 164.
[854] Guiding Case No 10, *Li Jianjun v Shanghai Jiadongli Environmental Science and Technology Co., Ltd* (04 June 2010) issued by the SPC, 18 September 2012.

whether and how to address it in its articles. As previously discussed,[855] there is no consent among the legal scholars whether the provisions of guiding cases are legally binding, but since the lower courts tend to follow the SPC's guiding cases, the 2012 decision is at least highly persuasive.

The revised Guidelines on Articles of Association of Listed Companies[856] (AA's Guidelines), which constitute model articles for Chinese listed companies, have finally provided some clarity. The previous version of Article 96 of the AA's Guidelines expressly prohibited directors' dismissal without cause, which suggested that the CSRC, responsible for issuing the Guidelines, considered it to be the optimal rule, which was confusing given the fact that such a prohibition had been removed from the Company Law in 2005. Keeping this provision in the AA's Guidelines by the CSRC despite multiple amendments to the Guidelines after 2005 could perhaps be considered as acting ultra vires since the securities regulator is only empowered to issue regulations in accordance with the existing laws. Article 96 was finally amended in April 2019 to provide that a director may be dismissed by the general meeting before the expiration of the term of his or her office.[857]

5.4.2. Selected Corporate Governance Mechanisms

Since China adopted a German/Japanese two-tier board structure,[858] apart from a board of directors Chinese listed companies are also required to have a board of supervisors.[859] The board of supervisors, responsible for overseeing companies' directors and senior management, must consist of democratically elected workers' representatives and candidates elected by the shareholders with the former constituting not less than one-third of the entire board.[860] Supervisors can propose removal of any director at the general meeting,[861] which is often ineffective, especially when a particular director is backed by the controlling shareholder. The position of supervisory boards in China is therefore considered too weak to have an adequate monitoring and disciplining effect.[862]

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[855] See page 95.
[856] Shangshi gongsi Zhangcheng Zhiyin [Guidelines on Articles of Association of Listed Companies] promulgated by the CSRC, 30 September 2016 (Revised 2018).
[857] Guanyu Xiugai 'Shangshi Gongsi Zhangcheng Zhiyin' de Jueding [Decision to Amend the Guidelines on the Bylaws of Listed Companies] issued by the CSRC, 17 April 2019.
[858] Tricker, *Corporate Governance: Principles, Policies, and Practices* (Oxford University Press, USA 2009) 21.
[859] CL, art 117.
[860] CL, art117 ('The workers' representatives shall be democratically elected through the workers' congress, workers' general meeting or other means').
[861] CL, arts 53(2) and 118.
[862] Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125, 165.

There is no requirement of separation of the positions of a CEO and a chairman under the existing corporate regime.

To further strengthen the monitoring role of the corporate governance, China's Company Law requires listed companies to have independent directors on the board,[863] with at least one-third of the board members being independent as specified in the Guidelines for the Establishment of Independent Directors System by Listed Companies[864] (Independent Directors Guidelines). Independent director is defined as a person who does not hold any position in the company other than a director, and who has no relationship with the listed company and its major shareholders that could hinder his or her ability to make objective and independent judgments.[865] Despite appearances, such a broad provision may be ineffective in ensuring independence of selected directors as it does not provide any meaningful constraints and guidance as to their independence.

Among the main duties of independent directors is the examination and approval of major related-parties transactions, the formulation of opinions on issues such as nomination, appointment and removal of directors and matters that may prejudice the interests of small- and medium-sized investors.[866] It may appear that the functions of the supervisory board and independent directors are somehow overlapping.[867] However, there are relevant differences between the two bodies: the independent directors are focused on monitoring the executive directors, whilst the supervisory board is expected to supervise the company's financial performance and the conduct of the board of directors in general. Chao Xi considers the functions of the boards as complementary, since the supervisory board's monitoring function has more of an *ex-post* character, whereas independent directors tend to oversee the board *ex-ante*.[868]

To advance the interest of small- and medium-sized investors, shareholders who individually or collectively hold at least 1% of shares in the listed company can nominate candidates for the position of independent directors.[869] This is however unlikely to protect the interests of such investors because independent directors can also be nominated by the incumbent board of directors, the supervisory

[863] CL, art 122.
[864] Guidelines for the Establishment of Independent Directors System by Listed Companies, promulgated by the CSRC, 16 August 2001, art 1(3) (Independent Directors Guidelines).
[865] ibid, art 1(1).
[866] ibid, arts 5-6.
[867] 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.
[868] ibid 27.
[869] Independent Directors Guidelines, art 4(1).

board and other shareholders holding at least 1% of the company's shares.[870] In practice nomination often comes from the controlling shareholder or from the existing executive directors,[871] which is not surprising given the dominant ownership structure of China's listed companies and characteristics of its shareholders.[872] Clarke puts forward suggestion that one of the main functions of independent directors' in China is to serve the public interest, rather than to protect minority shareholders,[873] arguing that such directors assume the role of an agent of the state to monitor the company's assets on its behalf in order to minimise managerial waste. However, an empirical study by Liao, Young and Sun[874] reports that only 14% of independent directors have political connections,[875] including 8% of politically connected outsiders, and 6% of retired bureaucrats. In light of this empirical evidence, Clarke's argument does not seem plausible because one would expect an agent of the state to be politically connected. On the other hand, directors with political connections backed by the state, even being in a minority may nevertheless significantly influence corporate affairs and provide a means for state intervention.

5.4.3. General Duties of Directors

Article 147 of the Company Law imposes on directors a duty of diligence and a duty of loyalty, owed to the company. Article 147 further stipulates that directors '… shall not take advantage of their functions and powers to accept bribes or collect other illicit earnings and shall not take illegal possession of the property of the company'. It thus appears that a corporate director must not accept benefits from the third parties because that person is a director or encroach company's property. Although it is not clear what exactly is meant by the 'property of the company' and whether the 'corporate opportunity' falls under the company's property under Article 147, Article 148 of the Company Law explicitly provides that director is prohibited from seeking business opportunities that belong to the company without consent of the general meeting. Article 148 further outlines a number of prohibited actions related to the duty of loyalty such as entering into a contract with the company by violating the law, loaning the funds of the company, using the company's property to provide guarantee for others without the company's consent or illegally disclosing company's confidential

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[870] ibid
[871] Clarke, 'The Independent...' (n862) 169.
[872] For a discussion on China's ownership structure see pages 152-152.
[873] Clarke, 'The Independent...' (n862) 169.
[874] Liao, Young and Sun, 'Independent Directors' Characteristics and Performance: Evidence from China' < https://www.ssrn.com/abstract=1489088 > accessed 10 April 2019.
[875] Political connections are identified by examining whether directors act or used to act as an officer within central or local government, or military.

information. The law does not further address the general duties of directors.[876] The concept of the duties of care and loyalty is therefore underdeveloped in China. General provisions do not provide enough clarity as to what is expected from the directors and how it should be judged whether or not directors breach their duties. Whilst the DGCL in Delaware and the CA 2006 in the UK do not specify the precise nature of directors' duties either, the principle is well-established and recognised through decisions of the courts. Private litigation over directors' duties in China is rather limited and therefore has not become an essential force in providing guidelines to develop the concept of directors' duties.[877] According to Wang, the judicial understanding and interpretation of fiduciary duties in China are rather different to that of the judiciaries in countries with common law traditions.[878] Wang documented a number of cases in which the courts used Article 147 of the Company Law to apply the doctrine of torts in civil law to the wrongdoings of corporate directors. Thus, the codification of fiduciary duties in China presents a possibility for the judges to use this concept as an authorisation by the law to impost tortious liability on company's insiders, which was not possible before the introduction of directors' duties to the Company Law in 2005.[879] Moreover, Xu and others report the attempts of the CSRC to apply the concept of directors' duties in some of its penalty decisions.[880]Although the manner in which a duty of diligence and a duty of loyalty have been applied was described as fairly 'sophisticated',[881] the CSRC did not seem to further develop or interpret the concept of directors' duties in China.

5.5. Directors' Role in the Takeover Context

When faced with a proposed acquisition the board of directors in China is not required to become actively involved in the transaction to obtain better arrangements for the company's shareholders (such as higher premium per share or finding a more suitable bidder). There are, however, certain responsibilities clearly articulated by the Takeover Measures which directors are expected to

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[876] Bu, *Chinese Civil Law: A Handbook* (Bu ed, Hart Publishing 2010) 36.

[877] Cases involving intentional wrongdoing eg, stealing or misappropriating the corporate seal by the directors have been documented. Based on the examination of the recent courts' decisions, Howson claims that Chinese judges strive to understand and articulate critical aspects underlining fiduciary duties, the appropriate standard for their breaches and the BJR presumption. Howson, 'Twenty-Five Years on—the Establishment and Application of Corporate Fiduciary Duties in Prc Law' in Criddle, Miller and Sitkoff (eds), *The Oxford Handbook of Fiduciary Law* (Oxford University Press 2018).

[878] Wang, 'Enforcing Fiduciary Duties as Tort Liability in Chinese Courts' in Huang and Howson (eds), *Enforcement of Corporate and Securities Law: China and the World* (Cambridge University Press 2017) 162.

[879] ibid

[880] Xu and others, 'Directors' Duties in China' (2013) 14 European Business Organization Law Review 57, 87.

[881] ibid 87 (different punishments were given for different breaches of duties).

fulfil during the tender offer. The target board should conduct due diligence on the acquirer, analyse the conditions of the offer, hire an independent financial advisor to issue a professional opinion, and recommend to the shareholders whether or not to accept the bid.[882] If any changes are made to the offer by the acquirer over the course of the bid then the board should adjust its recommendation accordingly.[883] Other than that, directors are required to carry on their usual duties and are not allowed to resign while the offer is pending.[884]

Some of the conduct prohibited by the general provisions of Article 148 of the Company Law is particularly applicable in the context of M&A transactions. Target directors are not permitted to loan corporate funds to others, to provide a guarantee to any other person by using the firm's property and to seek business opportunities for themselves or any other person. Such provisions clearly do not cover all contingencies that may arise during the takeover bid, therefore as a general principle, directors at all time must act in accordance with the duties of care and loyalty. Article 8 of the Takeover Measures describes the duties of the target directors in the context of takeovers in more detail. When dealing with unsolicited acquisitions, the decisions made, and actions taken by the board of the target with regard to a hostile offer shall be beneficial to the safeguarding of the interests of the target company and its shareholders and must not undermine their legitimate rights and interests.[885] Directors should not use their official powers to create inappropriate obstacles to the attempted acquisition.[886]

While Article 147 of the Company Law provides that the duties are owed to the company, both the company and its shareholders have been explicitly referred to as beneficiaries of directors' duties in Article 8 of the Takeover Measures. Such separation between the interest of the company and the interest of its shareholders gives rise to some uncertainty as it may potentially indicate that the interests of the shareholders and the company as a whole may differ. Moreover, Chinese law remains silent as to what exactly constitute the interests of the mentioned constituencies and whose interests take precedence in a conflict of interest scenario: those of the company or its shareholders. It is also not clear whether when referring to 'shareholders', the reference has been made to the shareholders as a whole or as a group of individual shareholders, whether it refers to the current and future shareholders, or just the current ones. To the author's best knowledge, there are no laws, regulations, judicial interpretations,

[882] TM, art 32.
[883] ibid
[884] TM, art 34.
[885] TM, art 8.
[886] ibid

guiding cases or even judicial decisions in China,[887] which would clarify the issue of whose interests take priority in the context of hostile takeovers. With regard to China, there has not been a single case involving a private action that would address the concept of directors' duties in a change of control context involving listed companies. There are decisions issued by the CSRC that mention general duties, where the CSRC was focusing on enforcing the specific disclosure rules, rather than applying, interpreting, and developing the content of fiduciary duties in a takeover context.[888]

5.5.1. Defensive Responses to Hostile Takeovers

The use of defensive mechanisms in a hostile acquisition is mainly governed by two articles contained in the Takeover Measures: Article 8 and Article 33. Although Article 8 of the Takeover Measures provides that improper barriers to the takeover shall not be established by misusing authority, it is not clear what 'improper' means in this context. It seems that the board generally is not obliged to stay neutral as long as defensive tactics would be used to protect legitimate interest of the company and its shareholders without abusing any of its powers. On the other hand, Article 33 of the Takeover Measures stipulates that:

> After the purchaser has made a suggestive announcement and before the tender offer is completed, the board of directors of the company under takeover may only continue to engage in normal business operations and carry out the resolutions made by the general assembly of shareholders prior to the announcement; but may not, without the approval of the general meeting of shareholders, take actions resulting in any significant effect on the assets, liabilities, entitlements or business performances of the company by disposing of the assets or external investments of the company or adjusting main businesses, guarantees or loans of the company etc.

The Article appears to intend to prohibit arbitrary post-offer defences by listing measures that must not be taken unless approved by the shareholders' general meeting and by requiring normal course of business operations during the takeover bid. It seems, however, that measures employed by the means other

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[887] The author attempted to analyse judicial decisions to understand to whom directors of listed companies predominantly owe fiduciary duties: to the company or its shareholders. To obtain data from the court system an active search has been performed using the Beijing University judicial cases database <www.pkulaw.cn/Case/> for the concept of 'zhongshi yiwu' (忠实义务) [duty of loyalty] and the concept of 'qinmian yiwu' (勤勉义务) [duty of diligence] under case category on company, securities, and other civil disputes between the years of 2006 -2017. The result is consistent with the findings of Huang and Chen (n28) 227.

[888] Chen (n17) 127-8; Huang and Chen (n28) 227; Xu and others (n880) 87.

than the actions restricted by Article 33, taken in accordance with existing laws, regulations and the company's AAs may be lawful, even if they have a frustrating effect on the bid. When Article 33 is read in conjunction with Article 8, there is, however, lack of clarity as to whether the target board is allowed to use takeover defences to fend off an unwelcome acquisition, and if so, what type of defences are permitted under the existing regime. The limited number of hostile acquisitions in China does not provide much guidance as the decisions made by the relevant authorities were inconsistent and varied on a case-by-case basis.[889]

Moreover, definition contained in Article 33 of the period during which a target board of directors is not allowed to engage in certain type of activities, i.e. after the bid announcement and before completion of the tender offer, leaves the doors open to interpretation that takeover defences may be permitted if they are carried outside of the period specified.

Although there is no consensus amongst Chinese legal scholars regarding the legality of takeover defences in China, the most common opinion is that the prevailing rule governing the board's conduct in the context of hostile takeovers is a form of board neutrality.[890] Zhang Lin argues that the Takeover Measures clearly proscribe the use of post-offer defensive tactics while allowing pre-offer defences.[891] Juan Chen describes the Chinese takeover regime as the 'UK model in books' and the 'US model in practice' meaning that the law originally intended to follow the UK model of board neutrality, but the transplanted rules lack supplementary regulations and enforcement mechanisms existing in the UK which consequently leaves the board of directors with a broad discretion in employing defensive tactics.[892] On the other hand, according to Wei Cai, even though the existing regime in China does not openly address the legitimacy of most defensive tactics, the Chinese regulatory authorities implicitly allow listed companies to include certain anti-takeover provisions in their articles.[893] Hui Huang suggests that the process of development of the rules governing board conduct using legal transplant of two jurisdictions may result in discrepancies within the single regime, and therefore, in China there are some areas where

[889] Cai, 'Hostile Takeovers...' (n10).
[890] Yu, 'Takeovers in China: The Case against Uniformity in Corporate Governance' (2005) 34 Common Law World Review 169, 189; Huang, 'The New...' (n825); Zhang, 'The Potential Rise of Hostile Takeovers in China: Efficiency , Politics and Law' (2014) 12 China: An International Journal 136; Varottil and Wan (n21).
[891] Zhang 'The Potential Rise…' (n890).
[892] Chen (n17) 138.
[893] Cai, 'Hostile Takeovers...' (n10) 934.

Article 8 overlaps, and even conflicts with, Article 33 due to the blurred boundary of the latter.[894]

5.5.1.1. Pre-bid Defences

Since Article 33 of the Takeover Measures is contained in the chapter named 'Takeover by Tender Offer', Cai argues that the provision is only applicable to acquisitions by an official tender offer.[895] Indeed, it seems that Chinese law allows anti-takeover measures if they are adopted before the official start of a contest for control, providing that, in accordance with Article 8 of the Takeover Measures, they do not involve abuse of power by the company's directors nor harm legitimate rights and interests of the company and its shareholders. The concept of directors' 'abuse of power' is not further explained.

Many Chinese companies include anti-takeover provisions in their articles. After having closely analysed the AAs of 40 firms listed on Shanghai and Shenzhen stock exchanges, Fang Zhang concluded that most of them adopted certain pre-bid takeover defences. The articles of the majority of the companies examined included one or more of the following defences: staggered board, golden parachutes, supermajority voting provisions, restrictions regarding nomination, election and removal of directors, restrictions on the rights on bringing the proposals.[896] Similarly, Juan Chen examined the articles of 150 listed Chinese firms and concluded that 73 of them adopted certain anti-takeover provisions. The most common provisions included: restrictions regarding nomination, election and removal of directors, restrictions on the rights on forwarding the proposals and provisions allowing the board to implement certain anti-takeover measures without prior approval from the shareholders. In addition, more than 75% of the remaining companies had a controlling shareholder which in itself constitutes a powerful defence against a hostile acquisition. [897]

5.5.1.1.1. Entrenchment Provisions

In both empirical studies,[898] special provisions related to the election of the new directors were the most commonly used pre-offer defences which aimed to deter potential acquirers from ever making a bid. Since the Company Law only guarantees shareholders the right to elect the members of the board, the nomination committee has a lot of discretion in drafting the nomination

[894] Huang, 'The New...' (n825) 173.
[895] Cai, 'Hostile Takeovers...' (n10) 914.
[896] Fang Zhang, Shangshi Gongsi Zhangcheng Zhong Dongshi Xuanren Tiaokuan de Youxiaoxing Fenxi [The Validity of the Directors' Appointment Provision in the Articles of Association of Chinese Listed Companies] (2009) 1 Faxue [Law Science] 122.
[897] Chen (n17) 154-160.
[898] Zhang 'The Validity…' (n896) and Chen (n17).

procedures.[899] Such procedures may be prone to directors' self-serving agenda providing a possibility of inclusion of the rules that are designed to restrict the right to nominate candidates to the board and therefore may result in an additional obstacle to changing the *status quo* in the event of a hostile takeover.

Although shareholders holding 3% or more shares are allowed to nominate directors by the way of submitting the shareholder proposal,[900] the nomination committee's responsible for drafting the election procedures, may supply the incumbent board with the right to review nominations proposed by the shareholders. Requirement of an approval of nominees by the majority of the board or an introduction of certain criteria restricting shareholders' rights to nominate the candidates, e.g. by requiring a minimum holding period (in practice usually 90 or 180 days) may help to protect the position of the company's incumbent directors.

Another provision commonly present in the firms' articles according to Feng Zhang and Juan Chen's studies involved the prohibition of directors' removal without cause. The fact that the issue remained ambiguous under the existing laws and regulations[901] provided an incentive for the companies to include such a clause in their articles. As a result, even if acquirers purchase enough shares which potentially give them the right to convene a special general meeting to replace the incumbent directors with their own nominees, the provision in the company's articles prohibiting removal without cause would make such operation very difficult. The potential acquirer thus may need to wait until the expiration of the directors' office to gain the seats on the board, which in China may take up to three years (the maximum term of directors' office stipulated in the Company Law[902] is three years; the exact term should be specified in the company's AAs), which almost certainly has an effect of deterring unsolicited takeovers. It is too soon to judge whether the amendment to Article 96 of the AA's Guidelines[903] will prompt listed companies to remove the provision from their articles.

The acquirer may have to wait even longer to gain a control if the board of the target company is staggered as it appears that listed companies in China are allowed to stagger terms of their boards since the law neither explicitly forbids nor permits such practice. The Company Law only outlines the required size of

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[899] See Part 5.4.1.
[900] The threshold is 1% for nominating independent directors, see page 111.
[901] See pages 109 - 110.
[902] CL, arts 45 and 108.
[903] ibid

the board (between 5 to 19 members)[904] and the maximum term of directors' office. The fact that the Company Law provides for the longest term of office of a director instead of the longest term of office of the entire board indirectly legitimises the existence of staggered boards in China. The AA's Guidelines[905] stipulate that directors' term should end upon expiration of the term of the incumbent board of directors, which, on the other hand, may suggest a preference for the declassified board over the staggered one.

5.5.1.1.2. Shareholders Rights Plan (US-style Poison Pill)

It is worth noting that the shareholder rights plan, considered the most potent anti-takeover mechanism,[906] has not been adopted by the firms analysed by either Feng Zhang or Juan Chen. A US-style poison pill does not exist in China because, as explained by the Centre for Financial Market Integrity,[907] it would be against the Company Law's provision prohibiting issuing shares at a discount or, as explained by Juan Chen,[908] mainly because it would violate the Securities Law's provision affording equal legal status to the parties of share issuance.

These explanations, however, do not seem to present the whole picture in regard to why the pill is not popular in China. To create a poison pill the company must first issue a warrant by means of an interim dividend to each shareholder for every share held. The warrant attaches to and is transferred with the share until exercised. A 'shareholder rights plan' setting forth the terms of the pill provides for exercise terms which are out of money until a certain triggering event (usually a situation when an acquirer not approved by the board crosses an ownership threshold specified in the plan – typically 10-15%). Occurrence of the triggering event changes exercise terms of the warrant proving holders of the warrant, apart from the one who crosses the said threshold, with a right to purchase company's shares at a significant discount (flip-in pill).[909] Thus, it may be argued that the observed differential treatment between the bidder and other shareholders in relation to the exercise of the warrant violates the principle of

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[904] CL, art 108.
[905] AA's Guidelines, art 96.
[906] Ruback (n33) 54.
[907] Centre for Financial Market Integrity, 'Shareowner Rights across the Markets. A Manual for Investors' (2009) </www.cfainstitute.org/-/media/documents/support/advocacy/shareowner-rights/ccb-v2009-n2-1.ashx> accessed 10 May 2018.
[908] Chen (n17) 152 ('It is against the requirement of equal status to issue the rights of stock acquisition to non-acquirer shareholders and to exclude the rights of acquirer-shareholders to obtain shares at discounts').
[909] Kershaw, *Principles of Takeover Regulations* (n445) 336.

equality[910] pursuant to Article 4 of Securities Law. The equality principle under Chinese law has been broadly interpreted as being inclusive of the rights of parties in securities issuance, equality between and among natural persons and legal persons, and the right to enjoy equal protection under the law.[911] However, if one takes a view of Kershaw that the requirement of equal principle of shareholders may not necessarily prevent the differential treatment arising from a pill because the pill rights constitute contractual rights to buy shares independent from the rights attached to shares,[912] then it can be argued that constructing a poison pill in China does not require a violation of equality principle under the Securities Law. Thus, despite differential treatment arising from the pill, there is no unequal treatment in relation to issuing interim dividends of warrants or issuing shares because the acquirer, similarly to other shareholders, was issued the proportionate number of warrants with the same exercise terms. Yet, unlike other shareholders, the acquirer did not comply with the terms set forth in the warrant as he crossed the ownership threshold without prior approval of the board and, as a result, he cannot exercise the contractual right to purchase company's shares at a discount. As a result, the Securities Law's provision affording equal legal treatment is not contravened.

In regards to the Centre for Financial Market Integrity's argument, one must note that when the company issues new shares to outside investors, the Administrative Measures for the Issuance of Securities by Listed Companies (Issuance of Securities Measures), [913] require the price of the new shares not to be lower than the average price of the company's shares during the 20 days prior to the announcement of the intent to issue the shares or the average price of the transaction day prior to the issuance,[914] but no such requirement applies to issuance of the shares to the existing shareholders.[915] It thus suggests that such shares may be issued at a discount to the current market price. Issuance of shares in accordance with shareholders rights plan is also rather unlikely to violate the Company Law's prohibition of issuing shares below par value,[916] because the par value is often much lower than the current market price anyway.

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[910]Some courts in the US invalidated the pill because of its alleged discriminatory treatment, e.g. Avon Prod., Inc. v Chartwell Assoc. LP, 907 F.2d 322 (2dCir.1990); Asarco, Inc. v MRH Holmes A Court, 611 F. Supp. 468 (D.N.J. 1985), see Cox and Hazen, *Cox & Hazen on Corporations: Including Unincorporated Forms of Doing Business* (Aspen Publishers 2003) 1431.

[911] Yu, *China Business Law* (Palgrave Macmillan 2019) 87.

[912] Kershaw, *Principles of Takeover Regulations* (n445) 336.

[913] ibid, art 12(1).

[914] ibid, art 13(3).

[915] ibid, art 12.

[916] CL, art 127.

Thus, a viable reason for unpopularity of a poison pill in China may be linked to other procedural matters related to granting interim dividends and issuing new shares. Firstly, although formulating a dividend plan is within the scope of responsibilities of the board of directors,[917] the plan must be submitted for consideration and approval to the general meeting.[918] The pill, however, is created through the issue of a warrant by the means of interim dividend, the issuance of which is not dealt with explicitly by the existing laws and regulations. Thus, listed companies issue interim dividends in accordance with the listing rules of bourses they are listed on (SZSE Listing Rules and SSE Listing Rules do not contain provisions regulating the issue of interim dividends) and the articles of association, which may provide the board with a right to declare interim dividends[919]. Thus, availability of a pill seems to be on a case-to-case basis, depending on the company's charter. Moreover, issuance of new shares by the listed company must be approved by the shareholders' special resolution[920] and the CSRC.[921] The fact that the bidder (who triggered the pill) is likely to have a substantial stake at the company combined with a typically low level of voters' turnout in China[922] may render passing such resolution rather unlikely. Last but not least, pursuant to Article 12(1) of Issuance of Securities Measures, the number of shares to be issued to the incumbent shareholders cannot exceed 30% of the company's total capital, which would normally not be sufficient to create a powerful poison pill.

In terms of directors' duties, until the takeover offer is made by the bidder, creation of shareholder rights plan is governed by Article 8 of the Takeover Measures. Thus, as long as the pill is adopted in the best interest of the company and does not damage the shareholders' legitimate rights and interests, it seems to be within the range of measures available to the target board. Admittedly, the pill has a potential of damaging both economic and voting interests of a shareholder who crosses the predetermined ownership threshold, but only when the said shareholder does not comply with contractual terms set forth in the plan, otherwise all shareholders are provided with the warrant to purchase more shares in proportion with their stake in the company . If, however, the pill is to be adopted or realised after the bidder has made a takeover offer, then the board's possibility to lawfully use it as a takeover defence is further limited by Article 33 of the Takeover Measures, which will be discussed in detail in Part 5.5.1.2

[917] CL, arts 45 and 108.
[918] CL, arts 37 and 99.
[919] It is a relatively common practice in China. See eg, China Vanke's articles (n837).
[920] Issuance of Securities Measures, arts 41 and 44.
[921] ibid, art 46.
[922] See page 175.

below. One thing that should be stressed here with regard to Article 33 is that whilst it prohibits any major change in the target's equity, it is not clear what constitutes a 'major change' (and whether prospective issuance of shares would amount to a major change) what gives room to the lawyers to provide some creative solutions to the board of potential targets. Nonetheless, given the fact that the poison pill is typically adopted not to be triggered and 'swallowed' by the acquirer, but rather to operate as a deterrent, it seems that it can be used without the risk of contravening Article 33.

5.5.1.2. Post-bid Defences

Pursuant to Article 33 of the Takeover Measures, after the bid has been announced actions which either do not fall into the 'business as usual' category or involve exerting major impact on the company's assets, liabilities, equity or operational results through assets disposal, outward investment or adjustment to business are prohibited, unless the shareholders approve their use at the general meeting. Although it is believed that Article 33 was inspired by the UK's non-frustration rule, it might be interpreted as allowing directors to carry out activities which are not specifically prohibited under Article 33, even if doing so results in frustrating the bid after the commencement of the tender offer.

This current version of the Article 33 employs rather a generic description of the restricted defensive actions which broadened their scope in comparison to the first version of the article adopted in 2002. Article 33 contained in the 2002 Takeover Measures[923] provided that the measures taken by the company's directors in response to takeover activities shall not damage the lawful interests of the company and its shareholders[924]. It further added that after the bidder makes an indicative announcement, the target board of directors could only continue to execute the existing contracts or the resolutions already made by the general meeting, and should not carry on these six specified measures: (1) issuance of new shares; (2) issuance of convertible company bonds; (3) buying back its own shares; (4) modifying the company's AAs; (5) entering into contracts which may have material effects on the company's assets, liabilities, rights, interests or business results, except for the purpose of conducting the ordinary business of the company; and (6) disposing of or purchasing material assets, adjusting the principal business of the company, save in exceptional situations where the company adjusts the business or restructures the capital

[923] Shangshi Gongsi Shougou Guanli Banfa [Measures for the Administration of the Takeover of Listed Companies] promulgated by the CSRC, 28 September 2002 (expired) art 33 (2002 TM).

[924] Note that the first part of the original Article 33 now constitutes a separate Article 8 of the Takeover Measures.

when faced with serious financial difficulty.[925] The provision was considered to be under-inclusive[926] since it seemed that the target board was generally allowed to use defensive tactics other than the six actions named in the Article as long as employed defences were not damaging for the company and its shareholders.

This selective straight-out restriction on only number of actions while allowing other measures to proceed may seem rather puzzling. Yet, when comparing Article 33 of the 2002 Takeover Measures with Rule 21.1 of the UK's Takeover Code and Rule 4 of the HK Code[927] one can easily note that all defensive measures (except amending company's AAs) prohibited in Article 33 were also mentioned in the rules governing directors' conduct in takeovers of both codes. Such observation suggests that the most likely reason behind the strict prohibition of the six selected actions was simply the fact that the Chinese drafters copied the provisions found in the codes directly, without any serious consideration of their appropriateness in the Chinese context.

Abolishing the negative list of six actions and adopting a more generic approach by the current Article 33 to certain extend resolved the under-inclusiveness of the previous version.

The remaining issue of under-inclusiveness is partially solved by Article 8 of the Takeover Measures which prohibits defensive tactics harming the legitimate rights and interests of the company and its shareholders generated by the abuse of directors' power. Therefore, even if a measure does not have a major impact on the company and thus is not covered by Article 33 it would still fall under the prohibitive provision of Article 8 as long as it harms the interests of the company and its shareholders. It is, however, unclear what exactly constitutes those interests,[928] therefore there is some scope of using takeover defences that do not damage, at least seemingly, the 'interests of the company and its shareholders' but are nonetheless taken by directors for a self-benefiting purpose. Shareholders dissatisfied with directors' conduct can nonetheless step in and discipline the board since the Company Law equips shareholders with extensive control rights allowing them to instruct the board of directors of its will and wishes. Thus, despite the ostensible ambiguity of Article 33 of the Takeover Measures, by

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[925] 2002 TM, art 33.

[926] Huang, 'China's Takeover…' (n820) 176.

[927] The Codes on Takeovers and Mergers and Share Repurchases, 2002, r 4: '(…) In particular the offeree company's board must not, without such approval, do or agree to do the following: (a) issue any shares; (b) create, issue or grant, or permit the creation, issue or grant of, any convertible securities, options or warrants in respect of shares of the offeree company; (c) sell, dispose of or acquire assets of a material amount; (d) enter into contracts, including service contracts, otherwise than in the ordinary course of business; or (e) cause the offeree company or any subsidiary or associated company to purchase or redeem any shares in the offeree company or provide financial assistance for any such purchase.'

[928] See page 231 for discussion on the interest of company and shareholders in Chinese context.

making the general meeting the 'organ of power',[929] the law in China puts a substantial constraint on the range of defensive tactics the board can lawfully introduce if it does not have support from the company's shareholders.

Apart from being under-inclusive, the 2002 version of Article 33 was also over-inclusive in nature: for example, amending company's AAs during the takeover bid under the old regime was strictly prohibited even if the change was not intended to have a frustrating effect. The 2006 amendment also attempted to address the problem of over-inclusiveness. Although it has not been fully corrected until now, this issue is not overly troublesome because if the board believes that a certain action with an anti-takeover effect is nevertheless beneficial to the company, it may seek shareholder approval to implement the measure. The same procedure applies if the board wants to proceed with an action that is not intended to be used as a defensive device but has a major impact on the company or falls outside the scope of 'business of usual'. The provision remains consistent with the Company Law that gives extensive powers to company shareholders,[930] which results in the general meeting delineating the boundaries of application of Article 33 of the Takeover Measures.

Another potential issue regarding Article 33 is that neither the Takeover Measures nor the Company Law giving shareholders the right to vote on major transactions do not specify the meaning of 'significant' or 'major' effect which leaves some scope for the board to adopt defensive measures. For example, in case of a 'major' assets disposal which may affect company's attractiveness as an acquisition target it is not clear which amount of assets would constitute 'major' amount. Pursuant to Article 121 of the Company Law, if within a given year the amount of assets purchased or disposed by the company exceeds 30% of the total assets of the company, a special resolution must be passed by the shareholders to approve such transaction. Whilst the provision suggests a threshold of 30% of the total assets being a major amount, it does not provide any guidance as to how the total value of the assets should be measured. It may be in the board's discretion to determine the value of the company's assets, which can be measured based on e.g., the company's most recent balance sheet, or provided by the financial advisor prepared by applying a chosen asset valuation method.[931] The value received by employing these approaches may

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[929] CL, art 98.

[930] See Part 5.4.

[931] Vanke's board attempted to manipulate the price of the underlying assets when proceeding with the proposed asset restructuring transaction during the takeover battle with Baoneng. See Kruszewska, 'Target Board's Conduct and Shareholders Rights in the Context of Hostile Takeovers in China: A Case Study of Vanke v Baoneng' (SSRN, October 2017) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3385975> accessed 20 May 2018.

differ substantially. In light of this, the provision found in Article 8 prohibiting defensive actions harming the interest of the company and/or its shareholders is of particular importance to prevent the board from abusing its powers.

Lastly, whilst Article 33 of the Takeover Measures stipulates that certain types of post-bid defences shall not be used unless they are approved by the general meeting, it does not stipulate the required level of approval to be obtained and that the resolution must approve a specific defensive measure. The latter is particularly problematic as it potentially allows directors to secure a blank cheque permission for a specified period e.g. five years during which directors are free to adopt any anti-takeover measures. While the Company and Securities laws dictate that some types of actions require the authorisation of the general meeting by special majority, there is no specified requirement in relation to resolutions approving defensive measures. The board could be tempted to set the acceptance level for such a resolution lower than the simple majority of votes cast in favour of the defensive action, but Article 103 of the Company Law provides that a resolution made at the general meeting must be supported by at least half of shareholders with voting rights present at the meeting. Thus, the board's attempt to lower the acceptance threshold would violate the law, giving shareholders the right to object such practice under Article 22 of the Company Law, which entitles them to petition the court to invalidate a resolution passed in breach of law, regulations or the company's articles. The latest SPC's

Provisions on Certain Issues Concerning the Application of the Company Law of the People's Republic of China (IV)[932] (Provisions on Company Law IV) issued in 2017 further expanded on this right allowing shareholders to petition the court to invalidate a resolution that e.g., violated the requisite voting majority or one that was not passed at the general meeting.[933] The Company Law and the Provisions on Company Law IV thus restrict the availability of the above-mentioned practices.

5.5.1.2.1. White Knight

As mentioned earlier, it appears that directors in China are allowed to carry out actions which are not specifically covered by Article 33 of the Takeover Measures even if they could result in frustrating the bid as long as target directors meet the duties of loyalty and care. Pursuant to the Takeover Measures, all

[932] Zhonghua Renmin Gongheguo Gongsi Fa Ruogan Wenti De Guiding (Si)[Provisions of the SPC on Several Issues Concerning the Application of the Company Law of the People's Republic of China (IV)] issued by the SPC, 25 August 2017 (CL Provisions IV).
[933] CL Provisions IV, arts 1 and 5.

acquirers should be treated fairly,[934] but the concept of the fair treatment is not further explained. The Takeover Measures only provide that the board should not offer any financial assistance to any acquirer using the company's resources.[935] Therefore, it seems that as long as they act in good faith, directors are allowed to search for and solicit a friendly bidder. Although the strategy was particularly viable before the 2014 amendments to the Takeover Measures which removed the requirement of prior approval of the takeover by the CSRC as it delayed the takeover, it still can be successfully used nowadays especially when the transaction has to be approved by any other authority[936] or when the target opts for voluntary trading suspension which will provide the board with extra time to respond to a takeover.

5.5.1.2.2. Trading Suspension

A very unusual takeover defence from the perspective of more mature jurisdictions is the possibility of applying a prolonged discretionary trading suspension by a target firm. When a potential hostile acquirer appears on the horizon, the board of directors may suspend the trading of company's shares for some time to prevent the acquirer from accumulating a bigger stake, as well as to defer launching a tender offer by a suitor as done by the board of Vanke in the famous takeover battle against Baonang.[937] An incumbent board may use the time of trading suspension to search for a white knight, as the Securities Law remains completely silent on the issue of voluntary trading suspensions and the rules of both national bourses - Rules Governing the Listing of Securities on Shenzhen Stock Exchange[938] (SZSE Listing Rules) and Rules Governing the Listing of Stocks on Shanghai Stock Exchange (SSE Listing Rules)[939] neither define a strict limit to the period of trading suspension nor do they clearly specify the situations in which voluntary trading suspension is permitted.[940] According to the MSCI,[941] a leading provider of global equity indexes, in 2016 there were about 10% of firms in China under lock-up due to the voluntary trading suspension, compared to just 0.2% on average in the countries included in its

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[934] TM, art 8.
[935] ibid
[936] For examples of such authorities see page 102.
[937] Kruszewska, 'Target Board's …' (n931).
[938] Shenzhen Zhengquan Jiaoyi Suo Gupiao Shangshi Guize [Rules Governing the Listing of Securities on the Shenzhen Stock Exchange] 01 January 1998 (amended 2014) (SZSE Listing Rules).
[939] Shanghai Zhengquan Jiaoyi Suo Gupiao Shangshi Guize [Rules Governing the Listing of Stocks on the Shanghai Stock Exchange] 01 Janurary 1998 (amended 2018). http://english.sse.com.cn/laws/framework/c/4547752.pdf (SSE Listing Rules).
[940] SZSE Listing Rules, r208.
[941] Tan, 'China Regulator CSRC Measured, Stock Markets Muted Reaction to MSCI Decision', *CNBC* (14 June 2016) <http://www.cnbc.com/2016/06/14/chinese-a-shares-not-included-in-msci-em-index-china-regulator-csrc-says-reforms-will-continue.html.> accessed 19 April 2018.

MSCI Emerging Market Index (MSCI Index).[942] Moreover, voluntary trading suspensions usually last considerably longer in China than in many other markets, especially those mature markets of the UK and the US.[943] After having examined stock exchanges from various countries at different levels of development, the International Organisation of the Securities Commissions reported that all of them adopted rules regulating trading suspensions. China is among the few countries where the duration of the suspension is flexible depending on the triggering event,[944] while in most mature market jurisdictions there are fixed, transparent and strict rules regarding the length of trading suspensions.

China was pushing for an inclusion of its A-share market in MSCI Index since 2013 (when its equities were first rejected) because it had a potential to bring at least USD20 billions of capital into the Chinese securities market in the first year following the inclusion.[945] China's shares were finally partially included in MSCI Index in 2018[946] because its authorities managed to address major concerns raised by the MSCI, including arbitrary trading suspensions.[947] In May 2016 SZSE published a Memorandum on Trading Suspension and Resumption for Listed Companies (SZSE Memorandum)[948] which, the bourse admits, was partially formulated in response to recent 'emerging market situations',[949] which arguably included above-mentioned Vanke's prolonged trading suspension. Among the aims of the SZSE Memorandum was to 'safeguard the right to trade, the right to know and other legitimate rights and interests of investors' and to reduce discretionary element in China's securities market through strengthened regulation of suspension of trading.[950] The maximum duration of suspension

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[942] ibid

[943] After having examined stock exchanges from various countries (eg UK, US, Hong Kong, Turkey, Italy, Mexico, Poland, Switzerland) at different levels of development, the International Organisation of the Securities Commissions (OIOSCO) reported that all of them have arrangements in place for implementing trading suspensions. OICV- IOSCO, 'Report on Trading Halts and Market Closures' (October 2002) (Report on Trading Halts) <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD138.pdf.> accessed 17 June 2018.

[944] ibid 64.

[945] Wong, 'MSCi Tells China "No for Now" on Entry into EM Index' *International Advisor* (15 June 2016) http://www.international-adviser.com/news/1029821/msci-tells-china-entry-em-index. accessed 26 August 2016.

[946] MSCI, 'Making China Simple Again' <https://www.msci.com/china> accessed 10 April 2019.

[947] 'MSCI's China Inclusion at Risk of Stalemate on Control Issue' *Bloomberg News* (15 June 2016), <http://www.bloomberg.com/news/articles/2016-06-15/msci-s-china-inclusion-at-risk-of-stalemate-as-control-an-issue.> accessed 06 July 2016.

[948] Memorandum on Trading Suspension and Resumption for Listed Companies, issued by the SZSE, 27 May 2016 <http://www.szse.cb/main/en/AboutSZSENews/SZSENews/SZSENews/39759921.shtml/.> (SZSE Memorandum).

[949] It is not an uncommon phenomenon when an emerging situation triggers a regulatory response which creates new regulations that soon become part of the takeover regime. As noted by Davidoff Solomon, *Gods at War* (n332) the takeover regime in the US has been developed *ad hoc*, through the responses of the regulators and judges to emerging situations.

[950] SZSE Memorandum, s 70.

under the SZSE Memorandum is three months, available when the company faces major asset restructuring. If the suspension is expected to exceed three months, it must be approved by the general meeting.[951] Companies which e.g. sell or purchase new assets, make major external investment decisions or plan a transfer of controlling rights by a related party can suspend trading for a maximum of ten days.[952]

The SZSE Memorandum certainly helps to curb directors' desires to use trading suspension to pursue their own agenda, e.g. to stop a potential acquirer from purchasing more shares or to delay a takeover to buy some time to prepare a defensive strategy. However, if the board is backed by a controlling shareholder, securing shareholder approval to extend the period of trading suspension seems to be a mere formality, especially if only a simple majority is required (the majority required to approve the extension has not been specified in the SZSE Memorandum). Although, the effectiveness of the new rules aimed at the restriction of discretionary trading suspension appears questionable, it nonetheless constitutes a positive development in China's securities regulations, especially given the bourse's authority to take disciplinary actions against firms abusing trading suspensions provided by the SZSE Memorandum.

5.5.1.2.3. Tactical Delays (Using Merger Control Provisions)

In a situation when the board of directors has a limited space for manoeuvre it can apply the strategy of using provisions of other regulations to frustrate the bid,[953] especially given the possibility of requirement of obtaining approvals from various regulatory agencies before the acquisition can be completed. It supplies the target with an opportunity to suspend an unwanted takeover in order to discourage the unwelcome acquirer or to delay it until the company finds a suitable white knight. Merger control regime presents an example of how the existing law can be used to influence the success of a takeover bid in China.

Under Chinese law certain takeovers must obtain a prior approval from the SAMR in order to be completed. The longest statutory period of the merger review process under the AML is 180 days.[954] Contrary to the US's merger control under the Hart-Scott-Rodino Act[955] (a shorter review period for cash tender offers) and the EU's Regulation on the Control of Concentrations between

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[951] ibid
[952] ibid
[953] Ruback (n33) 63-64.
[954] There is a 30-day Phase I review period followed by, if considered necessary by the SAMR, a 90-day Phase II period, which can be extended (under special circumstanced) by up to 60 days. AML, arts 25-26.
[955] 15 days rather than 30 days. 15 USC, s18a (b)(1)(B).

Undertakings[956] (standstill obligation exemption)[957] China does not provide for special treatment of an acquisition via tender offer.[958] The lengthy statutory period is often extended in practice. The study conducted by the author[959] reports that the average time of the review of cases in which MOFCOM, the SAMR's predecessor,[960] made an adverse decision[961] is 210 days, beginning with the first submission of the application (which was often not initially accepted). More than two third of cases exceeded the timeframe prescribed by the AML, despite the fact that, pursuant to Article 26 of the AML, if the competition authority fails to make a decision within the period of 180 days, the transaction may be considered cleared and the parties may proceed with its implementation. This phenomenon can be explained by two observations. Firstly, if upon the expiry of the extended period of further review, the competition authority did not make a final decision, but suspected that a concentration may have an effect of eliminating or restricting competition,[962] the parties that originally submitted a notification often decided to 'voluntarily' withdraw it, just to submit it again a few days or a few weeks later. Secondly, the statutory 180 days period of review does not include the pre-acceptance phase of the review. According to the Measures for the Declaration of Concentration of Business Operators[963] (Concentration Declaration Measures), 'the clock' does not officially start from the date of notification but from the date the competition authority confirms that it received all relevant documents and that it accepts the application. In all except two[964] reported cases, the competition authority considered a notification incomplete when it was first submitted which usually extended the review period by at least 30 days.

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[956] Council Regulation No 139/2004 on the Control of Concentrations between Undertakings, 20 Jan 2004 (ECMR), art 7(2).

[957] A tender offer can generally be implemented as long as the concentration is lawfully notified, and the acquirer does not exercise any voting rights attached to the securities in question. It appears from the case No COMP/M.4730 - *Yara/ Kemira Growhow* that the exemption is applicable only where a controlling stake is obtained from multiple rather than a single seller.

[958] Since 2014 China provides a fast-track simplified procedure for 'simple cases'. The procedure is available in relation to cases that do not raise competition concerns, it does not matter whether the transaction is executed via tender offer.

[959] Kruszewska, 'Impact of Certain Provisions of Merger Control on Hostile Takeover Activities in China' (2019) 49(1) Hong Kong Law Journal.

[960] When the transaction is conditionally approved or prohibited.

[961] China's competition authority only publishes its decisions when a merger is conditionally approved or prohibited. In case of unconditionally approved transitions, only the case name, the parties concerned and date of completion of review are provided.

[962] Eg *MediaTek/Mstar*, *Marubeni/Gavilon*, *Glencore/ Xstrata*, *NXP/ Freescale*.

[963] Jingying Zhe Jizhong Shenbao Banfa [Measures for the Declaration of Concentration of Business Operators] promulgated by MOFCOM, 21 November 2009, arts 13-14 (CDM).

[964] *Novartris/Alcon* and *Uralkali/Silvinit.*

Since timing is one of the crucial factors for the success of hostile takeovers,[965] the prospect of a delay caused by the necessity of approval is certainly desirable for the target board of directors. The fact that the target company in China is afforded considerable opportunity to use merger control as a takeover defence, especially in the pre-acceptance phase of the review, perhaps even more so. Pursuant to Article 9 of Concentration Declaration Measures, when a concentration is realised by tender offer it is the firm that acquires control or decisive influence that is responsible for submitting a notification, while the target is required to provide its assistance during the process. In instances of unsolicited bids, contrary to negotiated deals, the bidder does not have access to the non-public information of the target which may be necessary to provide a complete documentation for notification. The competition authority can require 'other documents and materials' apart from those listed in Article 10 of Concentration Declaration Measures, retaining complete discretion to determine, without any specific timeframe, whether a notification is considered accepted.[966] Given the lack of clarity regarding documents required by the SAMR, the target board has an opportunity to employ delay tactics, especially since the only consequence for violating the obligation to provide information under the Concentration Declaration Measures is refusal to accept the notification.[967] Ironically, such outcome would suit the target firm because without the notification and, consequently, the SAMR's approval, it would be unlawful to complete the deal. Although not specified in the Concentration Declaration Measures, the target could also face financial penalties, as Article 52 of the AML provides the competition authority with the right to impose a fine of up to RMB100,000 (approximately GDP11,375)[968] on individuals or RMB 1 million (approximately GDP113,754) on firms that refuse to supply the relevant materials or information or obstruct investigation in any other manner. Article 27 of the Guiding Opinions on the Application for Concentration of Business Operators[969] (Guiding Opinions on Concentration Declaration) closes the gap between the AML and its implementing measures by explicitly stating that, apart from refusing to accept notification, the competition authority shall investigate in accordance with Article 52 of the AML the liabilities for violation of the

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[965] Sidak, 'Antitrust Preliminary Injunctions in Hostile Tender Offers' 30 Kansas Law Review 491; Petsa-Papanicolaou, *Success Factors in Mergers and Acquisitions: Complexity Theory and Content Analysis Perspectives* (DPhil thesis, University of San Francisco 2007).
[966] CDM, art 13.
[967] CDM, art 15.
[968] RMB 1 = GDP 0.11 as of 01 April 2019, this exchange rate will be therein used for converting RMB to GDP.
[969] Jingying Zhe Jizhong Shenbao de Zhidao Yijian (Guiding Opinions on the Notification for Concentration of Business Operators) adopted by Anti-monopoly Bureau of the MOFCOM on 06 June 2014 (Revised 2018) by the SAMR (Guiding Opinions on Concentration Declaration).

obligation to provide information. In comparison, under the EU merger control rules, the European Commission (EU Commission) can impose a fine of up to 1% of the concerned parties' aggregate annual turnover for intentionally or negligently providing incorrect or misleading information.[970] Thus, the fines imposed by the EU's competition authority are much higher than those imposed by China's competition authority, e.g. in 2017 the Commission ordered Facebook to pay a fine of EUR110 million for providing incorrect or misleading information during the investigation of Facebook's acquisition of WhatsApp.[971] Contrary to the position in China, this serves as a reminder for market participants that a failure to comply with the EU's merger regulations, including the obligation to provide correct information, can have significant financial consequences. The European regime is, therefore, more likely to deter potential offenders and makes it more difficult for the target to use merger control as a defensive tactic.

An unwanted takeover approved by the SAMR may still be delayed or stopped altogether by the target board if it decides to use its statutory right provided by the AML to challenge decision of the competition authority which approved the transaction.[972] The board may apply for an administrative reconsideration by the SAMR within 60 days after the decision was issued.[973] Furthermore, if the target board is dissatisfied with the decision of administrative reconsideration it can file an administrative lawsuit.[974] Although during the administrative review, execution of the specific administrative act generally shall not be suspended, the parties may be temporarily stopped from implementing an approved transaction under certain circumstances.[975] No challenge of merger decision has been documented in China,[976] therefore it is difficult to assess whether the implementation of the acquisition would be suspended in such a situation.

Even if there is no instance to deter or stop the takeover based on competition grounds, either due to not meeting notification thresholds[977] or an absence of the effect of eliminating or restricting competition, the target company could attempt to employ certain measures to create a competition case. By acquiring control

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970 ECMR, art 14(1).
971 European Commission, 'Mergers: Commission Fines Facebook for Providing Misleading Information About WhatsApp Takeover' Press Release (18 May 2017).
972 AML, art 53.
973 Zhonghua Renmin Gongheguo Xingzheng Fuyi Fa [Administrative Reconsideration Law of the People's Republic of China] promulgated by the NPC, 1 September 2017, art 9 (Administrative Reconsideration Law),
974 AML, art 53.
975 Administrative Reconsideration Law, arts 21-22 (eg, when suspension of execution is deemed necessary by the defending party or the administrative reconsideration organ).
976 Kruszewska, 'Impact of Certain…' (n959).
977 See n797.

over or decisive influence[978] in the bidder's close competitor, the target could establish a case for potential competition concerns.[979] Admittedly, Article 33 of the Takeover Measures prohibits any major change in the target's assets, business operations or equity after the bidder made an indicative announcement, but whether purchasing equity in another firm constitutes a material change depends on many factors, for example the number of shares to be acquired, the price to be paid, the method of payment, etc. Consequently, target may be able to become a significant shareholder of the acquirer's close competitor and a competition case may be created, if for example, it had a substantial stake at that company prior to the hostile tender offer, and additionally is required to purchase only a limited number of shares. A sudden and completely unexpected tender offer is nowadays rare. Before launching an official bid the acquirer often approaches the target board with a 'bear hug' proposal[980] or a genuinely friendly offer. Moreover, a tender offer is typically proceeded by a gradual acquisition of a target company's shares, which can be detected by the target board in China thanks to the extensive disclosure requirement discussed in Part 5.7.1 of this Chapter.[981] Therefore, a situation where a hostile bid can be expected, though the offer has not yet been announced, provides a good opportunity for the target company to build a significant stake in the acquirer's close competitor, as Article 33 of the Takeover Measures is applicable only after the acquirer has made an indicative announcement of the offer.

5.5.1.2.4. Lobbying the Authorities

It appears that lobbying the authorises is allowed under China's takeover regime. Given the importance of the public interest test in China's merger control,[982] target board may attempt to create a case for the SAMR even when pure competition considerations do not raise any concerns. Since the AML formally allows public interest considerations in the substantive assessment of any concentration case reviewed,[983] the board may inform the authorities regarding such issues as a negative impact of the takeover on the local community, the company's employees or even development of the national economy. Moreover,

[978] AML, art 20.
[979] While this constitutes a theoretical possibility, such conduct has not been seen in practice to the author's best knowledge. One of the aims of this thesis is to explore the possibilities of using defensive measures by the target, not only to show whether such practices actually exist.
[980] A 'bear hug' is an acquisition proposal (either private or public) made to the board of directors of the target company with an intention to move the board to the negotiation stage. See DePamphilis, *Mergers, Acquisitions, and Other Restructuring Activities: An Integrated Approach to Process, Tools, Cases, and Solutions* (Elsevier Science 2003)
[981] See page 135.
[982] AML, art 1.
[983] AML, art 15.

as third parties are often consulted by the competition authority during the review process,[984] the target board has an additional possibility to use the public interest defence if it manages to convince e.g. friendly suppliers or customers to raise similar concerns during the review.

Davidoff Solomon noted an increased importance of public relations and media involvement in the deal-making process in the US, especially in transactions with a strong regulatory component.[985] Since China can be considered a jurisdiction where, despite lessening administrative intervention in takeovers, regulators continue to play an important role, the board may use public relations to support the process of lobbying the relevant authorities. Target directors may, for example, express their negative opinion about the potential acquirer to the shareholders and the general public through the media. Such conduct is not prohibited under the Takeover Measures which leaves the board with a relatively broad discretion to engage in communication aiming to discredit the offeror in the eyes of the shareholders, the public and state regulators, and, ultimately, to frustrate the bid.

If a hostile takeover is attempted by a foreign investor, target board of a domestic company may use the provision set out by Article 31 of the AML, which stipulates that when a transaction involves a foreign firm and a domestic company, the concentration may be reviewed for national security considerations. Pursuant to the Circular on Establishment of Security Review System Regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors[986] (the Circular) which established a basic framework for national security (NS) review, a review is triggered if a foreign investor tries to take control over domestic enterprises operating in a military-related industry. Examples of these enterprises include those near key, sensitive military facilities, enterprises concerning national security, or enterprises bearing national security interests which deal with agricultural products, energy and resources, infrastructure facilities, transportation services, key technologies, and manufacturing of major equipment.[987] Foreign investors engaging in a transaction that falls under the Circular's regime are required to file an application to be considered by the Joint Committee.[988] Stanley notes that the

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[984] Harris and others, *Anti-Monopoly Law and Practice in China* (Oxford University Press 2011) 146.
[985] Davidoff Solomon, *Gods at War…* (n332).
[986] Guowuyuan Bangong Ting Guanyu Jianli Waiguo Touzi Zhe Binggou Jingnei Qiye Anquan Shencha Zhidu de Tongzhi [Circular on the Establishment of Security Review System Regarding Merger and Acquisition of Domestic Enterprises by Foreign Investors] issued by the General Office of the State Council, 3 February 2011 (Circular).
[987] Circular, pt 1.1.
[988] Circular, pt 4.1.

scope of the NS review in China is much broader than that of the US, with respect to both the sectors and types of transactions covered.[989] In fact, it appears that almost all change of control transactions, even those with no apparent link to the country's security can fall under the NS review requirement. It allows a target of a hostile takeover to exploit the framework in an attempt to sabotage the completion of the acquisition. Pursuant to Article 3 of the Provisions on the Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors[990] (Security Review Provisions), government agencies, national trade associations, and third parties (such as firms in the same industry, including upstream and downstream companies), which believe that a security review needs to be conducted are granted the right to propose such review. Although not explicitly stated in the law, it is quite likely that the regulator would accept a proposal for a review submitted by a domestic company that is amongst one of the parties in the transaction. In that case, if the board of the target provides a viable explanation as to why a given transaction should go through the NS review, it may be able to persuade the regulator to accept the proposal to evaluate such a deal. Even if the target board does not manage to do that, it can take advantage of Article 3 of the Security Review Provisions by finding a friendly trade association willing to submit the security review request.

Contrary to litigation, which imposes substantial costs (e.g. lawyers' fees) on the part of the plaintiff, the institution of the NS review process does not burden the firm with additional expenses. Therefore, by making a request to institute such a review, the target is given the possibility of involving the hostile acquirer in a process of extra layer of review without incurring any risk of adverse costs on its side. Delays caused by the review would allow the board to search for a white knight. When a transaction is identified as having potential impact on national security, completion of a transaction is prohibited. Alternatively, if the transaction has already been completed, a divestiture or implementation of other measures may be ordered to eliminate the effect on national security.[991] Therefore, the target's efforts may result not only in delaying the transaction but also in stopping it altogether.

[989] Stanley, 'From China with Love: Espionage in the Age of Foreign Investment' (2014) 40 Brooklyn Journal of International Law 1033.
[990] Waiguo Touzi Zhe Binggou Jingnei Qiye Anquan Shencha Zhidu de Guiding [Provisions on the Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors] promulgated by MOFCOM, 1 Sept 2011 (Security Review Provisions).
[991] Security Review Provisions, art 7.

5.6. General Provisions Regulating Takeover Bids

Under China's takeover regime all acquisitions must be conducted in line with the principles of openness, fairness and equality.[992] Article 6 of the Takeover Measures provides that none of the parties involved in a transaction may damage the rights and interests of a target company and its shareholders by taking advantage of the takeover.

5.6.1. Right to Information

The Securities Law,[993] the Takeover Measures[994] as well as the SSE Listing Rules[995] (the SZSE Listing Rules do not contain an explicit provision regulating this matter)[996] all require the target company and the relevant authorities to be notified when the acquirer purchases 5% of the company's outstanding shares. The acquirer must freeze its buying activities for a period of time[997] at each subsequent increment of 5% stake. In addition, if the shareholder (alone or with concerted parties) crosses 20% equity threshold it must file in a detailed report regarding its identity, intentions, possible competitive issues arising, etc. This provides the target board with an opportunity to identify potential acquirers and, if necessary, prepare its defensive strategy.

When the acquirer decides to make an offer, target shareholders[998] must be provided with the tender offer report including, among other things, the purpose of the takeover, an analysis of the effects of the takeover on the company, any arrangements for the sale of shares held by the remaining shareholder, and the follow-up plans for adjustment of the company's assets, businesses, personnel within 12 months post-acquisition.[999] The financial advisor hired by the acquirer must issue a detailed report commenting on, e.g. acquirer's purposes for a takeover and its ability to pay.[1000] The information provided by the acquirer (and all parties that are subject to disclosure obligation) must be truthful, accurate and complete, and shall not contain any false record, misleading statement or major omission.[1001] It is among the duties of the financial advisor employed by the acquirer to supervise whether the acquirer fulfils its commitments[1002] and to

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[992] TM, art 3.
[993] SL, art 86.
[994] TM, art 13.
[995] SSE Listing Rules, r11.9.1.
[996] The provisions of SL and TM apply nonetheless.
[997] Five days under Article 86 of SL (three days which account for a period of reporting and two days after the report); three days under Article 13 of TM.
[998] Bidder's shareholders can access this information when a public offer announcement is made (or before, at the general meeting if the bidder shareholders are entitled to vote on a transaction).
[999] TM, art 29.
[1000] TM, art 66.
[1001] TM, art 3.
[1002] TM, arts 65(6) and 71.

report its observations to the CSRC, local branch of the CSRC and the stock exchange should there be any discrepancies in the acquirer's conduct post-acquisition.[1003]

The target board must make a thorough investigation of the acquirer in order to bring forward recommendation on whether or not the shareholders should accept the offer.[1004] In addition, a professional opinion of an independent financial advisor hired by the target who reports whether the acquirer is financially capable to complete the proposed bid must be made available to shareholders, all within 20 days after the announcement of the offer.[1005] Consequently, the target shareholders are statutorily provided with extensive and easily accessible information on the offer from both the acquirer and the target boards as well as professional financial advisors independent from each other, which allows shareholders to make an informed decision based on, at least in theory, impartial information.

During the offer period, the purchaser is obliged to publish, on a daily basis, on the stock exchange's website the number of shares tendered preliminarily.[1006]

5.6.2. Right to Fair Treatment

Whilst Securities Law provides that all the terms set out in a tender offer shall be equally applicable to all target shareholders,[1007] the Takeover Measures stipulate that all shareholders that hold the same class of shares shall be treated equally[1008] which may create some uncertainty if there is more than one class of shares in a given company. Until recently this was not an issue, because Chinese listed companies could only issue common shares, but in the early 2010s China decided to introduce preference shares to its capital markets. Although Article 103 of the Company Law provides for a 'one share, one vote' principle, under the Administrative Measures for the Pilot Scheme on Preference Shares[1009] promulgated in 2014 listed firms can issue preference shares with limited or no voting rights attached. Therefore, it remains unclear whether e.g., the same price must be paid for all shares non-discriminatorily as stipulated in Securities Law, regardless the class of shares or whether the bidder can offer different prices for common shares and preference shares.

[1003] TM, art. 71.
[1004] TM, art 32.
[1005] ibid
[1006] TM, art 42.
[1007] SL, art 92.
[1008] TM, art 26.
[1009] Youxiangu Shidian Guanli Banfa [Administrative Measures for the Pilot Scheme on Preference Shares] promulgated by the CSRC, 21 March 2014, arts 2-3 (Measures on Preference Shares).

To ensure the fair treatment of shareholders, the offer must be addressed to all shareholders.[1010] Partial offers for more than 5% of the company's shares are allowed on a pro-rata basis.[1011] Price proposed by the acquirer may not be lower than the highest price paid to the company's shareholders within six months prior to the date of the indicative tender offer.[1012] In order to further provide for fair treatment, after the offer is launched the bidder is prohibited from purchasing or selling any shares in the target through any other means or under other terms than those specified in the offer.[1013]

In accordance with Article 88 of the Securities Law and Article 24 of the Takeover Measures, an investor that has acquired 30% of the issued shares must make a general offer to all company's shareholders to purchase all or part of their shares. Not only the bidder is not required to launch the full general offer under the MBR in China, but to avoid launching the bid altogether, the bidder may apply to the CSRC for an exemption which can be granted under a number of circumstances, e.g. when the target company faces serious financial difficulties and the acquirer proposes a rescue plan approved by the shareholders.[1014] The CSRC is further granted with the power to exempt any acquirer under any other situation recognised as necessary by the CSRC,[1015] which makes its discretion very broad. This was particularly important before the partial offers were formally allowed in China in 2006. According to Guanghua Yu, such a catch-all provision, if used liberally, makes the MBR partly irrelevant. [1016] Indeed, despite the fact that the CSRC's waiver was supposed to be granted only in exceptional circumstances, in practice full takeover bids rarely occur in China. The empirical research conducted by Wei Cai showed that acquirers which triggered the MBR were exempted by the CSRC in as many as 96% of cases.[1017] The cost of complying with the MBR had a dampening effect on China's domestic takeover market,[1018] which the CSRC tried to mitigate by granting the exemption from the rule too often. Moreover, as explained by Chao Xi, since takeovers in China have been largely executed in order to rescue listed SOEs, the acquirers were often able to receive an

[1010] SL, art 88; TM, art 23.
[1011] TM, arts 23, 43.
[1012] TM, art 35.
[1013] TM, art 38.
[1014] TM, art 62.
[1015] ibid
[1016] Yu, 'Takeovers In...' (n890) 189.
[1017] Cai, 'The Mandatory...' (n812) 667.
[1018] Xi, *Corporate Governance and Legal Reform in China* (Wildy, Simmonds & Hill Publishing 2009).

exemption because they presented the proposed acquisition as a rescue transaction involving a target with serious financial difficulties.[1019]

The common occurrence of the MBR exemption means that shareholders in China are likely to end up in a controlled firm as minority shareholders involuntarily, since they are not provided with a viable exit strategy. Moreover, partial bids potentially allow the acquirer to structure a transaction in a way to offer high consideration in the original offer and then, e.g. a few months later, to offer a lower price or a different form of consideration in the subsequent bid. There are no provisions in the Takeover Measures which would effectively safeguard the interests of shareholders against such coercive two-tier takeovers. Wei Cai argued that such a bid would not pass scrutiny of the CSRC which most likely would prohibit the making of the bid.[1020] The amendment to the Takeover Measures in 2014, however, provides that the CSRC no longer reviews the transactions *ex-ante*[1021] and, therefore, the protection of the CSRC against coercive offers is nowadays afforded to a much lesser extent.

5.6.3. Squeeze-out and Sell-out Rights

China's takeover regime does not provide for a statutory squeeze-out mechanism of dissenting shareholders.

At the same time, minority shareholders in China benefit from a statutory sell-out right, which provides that if, upon expiration of the takeover offer, the public float requirement is not met[1022] the listing of target's shares shall be terminated, in which case the remaining target shareholders are entitled to have their shares purchased by the bidder on the same terms as those stipulated in the original tender offer.[1023] Moreover, minority shareholders who challenge a resolution approving a merger as a result of which the existing target company will be dissolved are provided with an exit strategy through request for a compulsory purchase of its shares by the company.[1024] Under the existing regime there is no guidance as to the exchange ratio or shares valuation method for this type of transaction. [1025]

[1019] ibid 98.
[1020] Cai, *The Mandatory Bid Rule, Hostile Takeovers and Takeover Defences in China* (DPhil Thesis, The University of Hong Kong 2011) 156.
[1021] TM Amendment Decision (n796).
[1022] Public float requirement under Article 50 of SL is 10% if company's total share capital is more than RMB400 million (approximately GBP45,500 million) or 25% if company's share capital is RMB400 million or less.
[1023] TM, art 44.
[1024] CL, art 142(4).
[1025] Weng, 'Lifting the Veil of Words: An Analysis of the Efficacy of Chinese Takeover Laws and the Road to a "Harmonious Society"' (2012) 25 Columbia Journal of Asian Law 180, 193.

5.6.4. Right to Sufficient Time to Make Decisions

Tender offer must be left open for a minimum period of 30 days but no longer than 60 days after the offer has been launched.[1026]

Shareholders who preliminarily accept the offer have a right to withdraw their acceptance up to three trading days prior to the expiration date of the bid.[1027] As mentioned earlier, the shareholders must be kept informed on the progress of the offer acceptance rate on a daily basis, so an informed decision can be made whether or not to tender their shares.[1028]

5.6.5. The Role of Financial Advisors

China's takeover regime provides for an extensive involvement of financial advisors because both parties to a transaction are required to engage one. Since the financial advisors must be independent, they cannot be simultaneously employed by both the target board and the acquirer.[1029] The advisor of the acquirer must be registered in China and have adequate financial consultancy qualifications.[1030]

The main responsibilities of the target's advisor involve delivering a professional opinion on the bid to the shareholders and cooperating with the acquirer's advisor in due diligence.[1031] The acquirer's financial advisor has a broader range of responsibilities, one of which is conducting an extensive due diligence and reporting to the target shareholders whether the bidder is financially capable to complete a proposed offer.[1032] If the financial advisor believes that the acquirer makes an acquisition to damage the interests and rights of the company or its shareholders, it shall refuse to provide consultation services to the acquirer.[1033] This is particularly important since the acquirer may not launch the offer without first having hired the financial advisor.[1034] The advisor is required to familiarise the acquirer's directors and supervisors with their legal duties and obligations under the takeover offer and make sure that they understand them.[1035] It must also supervise the acquirer's compliance with the laws, regulations and fulfilments stipulated in the takeover report in the first 12 months following a completion of the takeover.[1036] Therefore, the bidder is

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[1026] TM, art 37.
[1027] TM, art 42.
[1028] See page 136.
[1029] TM, art 67.
[1030] TM, art 9.
[1031] See page 135.
[1032] ibid
[1033] TM, art 9.
[1034] ibid
[1035] TM, art 65(3).
[1036] TM, arts 65(6), 71.

placed under great scrutiny even before the offer commences and until one year after the conclusion of the transaction.

Chao Xi describes the position of the financial advisor in China as a private enforcer of takeover rules, doubting that such a role can be effectively fulfilled.[1037] The financial advisor is employed and remunerated by the acquirer and as such he/she has incentives to collude with the employer, and therefore cannot be trusted to diligently discharge their monitoring duties. It should however be noted that the acquirer's advisor may become jointly and severally liable for acquirer's conduct, and may be obliged to make payment if the acquirer does not pay the full consideration upon completion of the tender offer.[1038] Moreover, if any false record, misleading statement or major omission made by the financial advisor[1039] is discovered by the CSRC, it may impose a penalty consisting of confiscating any unlawful proceeds, imposing a fine up to five times the advisor's income (it is unclear whether the income refers to the annual income or income from the specific transaction) and suspending or revoking the advisor's business licence.[1040] In addition, persons directly responsible for unlawful conduct may be personally punished with a fine between RMB 30,000-100,000[1041] (approximately GBP 3,412-11,375).

Some of the financial penalties may seem severe at first but compared to the revenue that may come from the infraction, they are unlikely to be insufficient to deter the undesired conduct. Thus, the advisor in China may be vulnerable to the client's pressure and therefore should not be fully relied upon to play a monitoring role on behalf of the regulator. In order to address this issue, the CSRC has issued a series of supporting regulations that aim to increase financial advisors' accountability.[1042] Due to the widespread responsibility and the important role of financial advisor for takeover activities, all consultancy firms wishing to provide such services must obtain a special certification from the CSRC to work with M&A transitions,[1043] which can be revoked if the financial advisor no longer meets the requirements contained in the Measures for the Administration of Financial Consultancy Services for Merger, Acquisition and

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[1037] Xi, *Corporate Governance* (n1018) 88.
[1038] SL art 173; TM, art 36(3).
[1039] SL, arts 169, 223.
[1040] SL, art 223.
[1041] SL, art 223.
[1042] Shangshi Gongsi Binggou Chongzu Caiwu Guwen Zhuanye Yijian Fu Biao [Provisions for Filling and Report the Appendix Form of Professional Opinions of Financial Consultants on the Mergers and Acquisitions and Restructuring of Listed Firms] promulgated by the CSRC, 7 December 2017; Measures for the Administration of Financial Consultancy Services for Merger, Acquisition and Reorganisation of Listed Companies, promulgated.by the CSRC, 3 June 2008, art 2 (Measures for M&A Financial Consultancy Services).
[1043] Measures for M&A Financial Consultancy Services, art 2.

Reorganisation of Listed Companies[1044]. In addition, as the part of the monitoring and supervising framework, the CSRC can carry out off-site or on-the-spot inspections on the aspects including corporate governance, operations performance, risks status and practices of certified financial advisors.[1045]

5.6.6. Other Provisions

In 2014 the CSRC removed an *ex-ante* approval requirement of takeover transactions.[1046] Before the amendment to the Takeover Measures, all tender offers used to be subject to the CRSC's approval prior to launching the bid. The bidder was required to submit the tender offer report mentioned in Part 5.6.1 to the CSRC for an investigation whether the offer is consistent with the laws, administrative regulations and other related provisions.[1047] Only if the CSRC had no objection within the 15 days from the submission of the report, the acquirer could officially announce the offer. Nowadays, pursuant to Article 28 of the Takeover Measures, the acquirer shall notify a target company and make an offer announcement simultaneously without obtaining the prior approval from the securities regulator. If the transaction is a subject to the approval of other authorities, such information should be included in the summary of the offer report and the offer can only be announced after securing such approval.

Moreover, in order to protect target companies and their shareholders, China's takeover regime adopted some *ex-ante* measures aimed at minimising the risk of expropriation and looting following the successful acquisition. Companies with a very poor record of credibility in the securities market within the past three years, companies that are engaged or have been accused of engaging in major illegal conduct within the past three years or are currently unable to meet their debt obligations are all temporarily banned from the takeover market.[1048] Another measure taken to further limit the opportunistic behaviour provides that the natural persons who fall into the provisions of Article 146 of the Company Law are also prohibited from launching a tender offer.[1049]

5.7. Enforcement of Takeover Regulations

In China it is public enforcement through administrative and criminal sanctions, rather than private enforcement, that plays more important role in the takeover

[1044] ibid, art 41.
[1045] ibid, art 37.
[1046] TM Amendment Decision (n796).
[1047] ibid
[1048] TM, art 6.
[1049] ibid

regime.[1050] The CSRC became the regulator and supervisor of the securities market since the enactment of the Securities Law in 1998 that introduced harsh administrative penalties and strengthened the power of the CSRC, while not containing any meaningful civil liability and civil compensation provisions.[1051] This resulted in practically non-existent private enforcement of corporate and securities laws in China because the Chinese courts generally refused to hear such cases due to the lack of certainty and guidance as to whether a private right of action was allowed under newly enacted laws.[1052] In its Several Provisions on the Relevant Issues Concerning the Acceptance of Cases of Disputes over Civil Tort Arising from False Statement in the Securities Market[1053] (2002 Securities Law Provisions) issued in 2002, the SPC instructed lower courts to accept shareholders' claims for misrepresentation. However, certain restrictions, such as available causes of action, explicit no class action mechanism and jurisdictional requirements favouring defendants, functionally impeded shareholders' ability to file a suit.[1054] The Several Provisions on the Trial of Cases of Civil Compensation Arising from the False Statement in Securities Market[1055] (2003 Securities Law Provisions) provided investors with the possibility of indicating both firms and individuals (e.g. directors, senior managers and controlling shareholders of a listed company) as defendants in their suit.[1056] The 2005 amendments to Securities Law further increased the CSRC's power, but did not significantly improve civil remedies.

5.7.1. Public Enforcement

Maintaining market order and ensuring the lawful operation of the markets[1057] are among the main functions of the CSRC. In the takeover context, the CSRC can exercise its supervisory role through regulatory talks, issuing warning

[1050] For example, 296 sanctions against false statement have been imposed by the CSRC since the enactment of Securities Law while the number of civil false statement cases is almost three times smaller. Huang, 'What Shapes Private Securities Enforcement in China? An Empirical Study of Chinese Securities False Statement Civil Compensation Cases' [2017]; Layton, 'Is Private Securities Litigation Essential for the Development of China's Stock Markets?' (2008) 83 New York University Law Review 1948, 1964-5.
[1051] Layton (n1050).
[1052] ibid
[1053] Zuigao Renmin Fayuan Guanyu Shenli Zhengquan Shichang Yin Xujia Chenshu Yinfa De Minshi Qinquan Jiufen Anjian Youguan Wenti de Togzhi) [Circular on the Relevant Issues Concerning the Acceptance of Cases of Disputes over Civil Tort Arising from False Statement in the Securities Market] issued by the SPC, 15 January 2002 (2002 SL Provisions).
[1054] Hutchens, 'Private Securities Litigation in China: Material Disclosure About China's Legal System' (2003) 24 University of Pennsylvania Journal of International Law 599.
[1055] Zuigao Renmin Fayuan Guanyu Shenli Zhengquan Shichang Yin Xujia Chenshu Yinfa De Minshi Peichang Anjian De Ruogan Guiding [Circular on Trial of Civil Damages Cases Arising from Misrepresentation in the Securities Market Several Provisions] issued by the SPC, 9 January 2003 (2003 SL Provisions).
[1056] Gu, 'Securities Arbitration in China: A Better Alternative to Retail Shareholder Protection' (2013) 33 Northwestern Journal of International Law & Business 283.
[1057] SL, art 178.

letters, imposing administrative penalties, ordering the companies to change their AAs to be consistent with the law, announcing directors as unfit to hold the position, suspending takeover transitions or terminating them.[1058] The most common actions used in practice are issuing warnings and imposing fines on wrongdoers.[1059] Among the most common type of illicit conduct in takeover transactions addressed by the CSRC is insider trading and non-disclosure of crossing the 5% ownership threshold.[1060] Hui Huang observed that the CSRC has very relaxed attitude towards adoption of anti-takeover measures by China's listed companies.[1061]

5.7.2. Private Enforcement

Where investors' rights were infringed during the course of a takeover, they can seek enforcement of these rights in court. The Company Law provides for civil law sanctions in the form of liability for damages caused by the company's insiders who, in the course of performing their duties (which includes duties in a takeover context) violate laws, administrative regulations or the company's articles.[1062] The Securities Law contains a wide range of civil law sanctions, but both judicial interpretations issued by the SPC (the 2002 and 2003 Securities Law Provisions) restrict the scope of cases for which the remedy can be sought. Only cases arising from misrepresentation, which includes false statements, misleading statements, material omissions, or improper disclosure, can be the subject of a private litigation. Thus, if shareholders' interests have been infringed in the course of a takeover due to directors' false, misleading or incomplete disclosure, e.g. involving statements included in the target board's response document, they are eligible to seek compensation for the losses suffered. Directors, supervisors, senior managers or any other party directly responsible, such as controlling shareholders,[1063] bear joint and several liability.[1064]

The forms of action against corporate violations include individual and derivative litigation. Firstly, under Article 152 of the Company Law, a shareholder can sue directors in their personal capacity if their acts directly affect the shareholder, for example, when their voting rights have been deliberately diluted, or when they receive insufficient or inadequate information.[1065] Under Article 151 of the Company Law, a shareholder or a group of shareholders is an

[1058] TM, ch 9.
[1059] Chen (n17) 128-9.
[1060] ibid 128-9
[1061] Huang, *Securities and Capital Markets Law in China* (Oxford University Press 2014) 304-5.
[1062] CL, art 149.
[1063] 2003 SL Provisions, art 7.
[1064] SL, art 69; 2003 SL Provisions, art 21.
[1065] Wang, *Company Law…* (n4) 221-2.

eligible plaintiff in a derivative suit if they collectively hold at least 1% of the company's shares for at least 180 consecutive days.[1066] The shareholder is first required to request in writing that either the board of supervisors or the board of directors (depending on the identity of the defendant) bring a suit to the court.[1067] The shareholder may proceed with a lawsuit on behalf of the company only if a designated organ refuses or fails to initiate legal action within 30 days from receiving the request or in cases where the failure to immediately file an action will cause irreparable damage to the interests of the company.[1068] Any damages awarded as a result of the derivative action are payable to the company.[1069]

The forms of action against securities violations include individual, joint and representative litigation.[1070] Pursuant to the Law of Civil Procedure[1071] (Civil Procedure Law), if cases brought by a number of different investors against the same defendant involve the same subject matter or a subject matter of the same category and the court considers that the actions can be consolidated then such case may be tried as 'joint action'.[1072] If the claims are of the same subject matter, the plaintiffs are required to participate in the same proceedings, but can opt out by expressly waiving their substantive rights upon court notification if they do not want to participate.[1073] If the claims concern subject matter of similar category, it is not mandatory to participate in the joint action, but the plaintiffs may opt in to the consolidated proceedings if other parties consent.[1074] If there are multiple plaintiffs[1075] to a joint action they may elect a party to 'represent' the interests of the group in the proceeding as a 'representative action'.[1076] Although Article 55 of the Civil Procedure Law further provides for 'group litigation',[1077] where the court may issue a public notice in which it states the particulars of the case informing that entitled parties may register within a certain period of time (opt-in approach), this form of action is not permitted in the case of securities disputes.[1078]

[1066] CL, art 151.
[1067] ibid
[1068] ibid
[1069] CL Provisions IV (n932), art 25.
[1070] 2003 SL Provisions, art 12.
[1071] Zhonghua Renmin Gongheguo Minshi Susong Fa [Civil Procedure Law of the People's Republic of China] promulgated by the NPC, 27 June 2017 (CPL).
[1072] CPL, art 53.
[1073] Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Minshi Susong Fa de Jieshi [Interpretation on the Civil Procedure Law] issued by the SPC, 30 January 2015, art 74 (Interpretation on the CLP).
[1074] CPL, art 53.
[1075] Ten or more than ten. Interpretation on the CPL, art 75.
[1076] CPL, art 54.
[1077] Where claims concern subject matters in the same category and there are multiple potential plaintiffs, but no exact number is determined at the time the suit is filed.
[1078] 2002 SL Provisions, art 4.

Derivative actions are easily accessible for shareholders in China. As noted by Clarke and Howson, there is no provision under the current regime that allows the company to argue that a legal action would not be in the company's interest, or that it has obtained adequate non-litigious remedies for the wrongdoing.[1079] Therefore, the only thing that can stop the investor qualified in size and term of shareholding from initiating a suit is the company initiating the suit itself. In light of this, it may be rather surprising that derivative actions brought by shareholders of listed companies are basically non-existent in China.[1080] The claims involving securities violations brought under Securities Law are more frequent and have been steadily growing in recent years,[1081] however, the majority of the cases involve small-claim disputes filed by individual shareholders of limited liability companies, whilst actions in the form of joint litigations by the shareholders of listed companies remain very rare in China.[1082]

The numerous procedural restrictions, especially in case of securities suits, hinder investors' ability to bring a lawsuit in the first place. For example, Article 18 of the 2003 Securities Law Provisions require the existence of a causal link between the defendant's wrongdoing and the plaintiff's loss, but causation cannot be established if the affected security was purchased before the misrepresentation was made.[1083] Moreover, under the securities law regime, for a private lawsuit to be admissible there is a prerequisite of an imposition of administrative penalty decision by a relevant authority[1084] or a criminal judgement made by the court.[1085]

Apart from the procedural restrictions, the reluctance of Chinese court to hear derivative suits significantly adds to the limitation of private enforcement.[1086] An empirical research conducted by Howson shows that politically or technologically complex cases are frequently not accepted by the Chinese

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[1079] Howson and Clarke (n767).
[1080] While there were many cases of derivative actions initiated by the limited liability companies, there was not a single derivative suit brought by a listed firm. Howson, 'Twenty-Five Years...' (n877).
[1081] For example, since 2014 Shanghai No 1 Intermediate People's Court, which up to establishment of a separate Financial Court in Shanghai had been the most active court in China in terms of handing financial and commercial cases, handled more than 1,600 securities cases, almost all of which were related to alleged misrepresentation. Liangtao, Fei and Cheng, 'Investor Activism on Rise in China' *Caixin Finance* (21 July 2017) <https://www.caixinglobal.com/2017-07-21/101120151.html> accessed 15 May 2018.
[1082] ibid
[1083] Gu (n1056) 294.
[1084] The CSRC, the Ministry of Finance or any other administrative organ.
[1085] 2003 SL Provisions, arts 5 and 6.
[1086] Lin, 'Derivative Actions in China: Case Analysis' (2014) 44 Hong Kong Law Journal 621; Howson and Clarke (n767); Tang, 'Protecting Minority Shareholders in China: A Task for Both Legislation and Enforcement' in Milhaupt, Kim and Kanda (eds), *Transforming Corporate Governance in East Asia* (Routledge 2008) 147.

courts.[1087] Courts' reluctance may be explained by the lack of expertise and experience needed for the adjudication of claims which require complicated reasoning.[1088] Moreover, because the courts are not politically powerful, they are unwilling to hear cases involving powerful or politically-connected defendants.[1089] Since it is typically a director or a controlling shareholder who would be a defendant in a derivative action, and, as discussed in Part 4.6, such parties often have very close ties with the state or the CPC, then another source of unwillingness to accept derivative suits by the courts seems to emerge.

The rules on litigation fees could be considered another obstacle contributing to China's relatively inactive private enforcement in the context of takeovers of listed firms. Firstly, China follows 'the loser pays' principle in the allocation of litigation costs, which means that in a case of a lost suit by the plaintiff shareholder, they are required to cover the costs of the winning defendant.[1090] On the other hand, in case of a won suit, the ruling court does not return the litigation costs to the winning party, rather, it is the loser who is required to directly reimburse the costs to the winner.[1091] A great number of cases in which the winners failed to recover their costs has been reported,[1092] mostly because the courts in China have no power to force the loser to pay the costs or because the courts do not enforce their rulings earnestly and with proper care.[1093] Such rules on litigation costs are likely to discourage shareholders (in particular small investors who hold only a small fraction of a company's equity) to bring in the suit in the first place.

Finally, even if the shareholder goes through all the troubles in bringing the case and manages to win it, he or she may expect to encounter difficulties with enforcement of the court judgment. Because of the local protectionism, the courts are unwilling to enforce out-of-region decisions issued by non-local courts.[1094] More than 800,000 court decisions were not enforced in years 2005 and 2006 alone.[1095] If coupled with the fact that the winner often has a problem with reimbursement of incurred expenses, it is understandable that shareholders

[1087] Howson, 'Corporate Law in the Shaghai's People's Court, 1992-2008: Judicial Autonomy in a Conemporary Authoritatian State' (2010) 5 East Asia Law Review 303.
[1088] Tang (n1086) 147.
[1089] ibid 147; Howson and Clarke (n767).
[1090] Susong Feiyong Jiaona Banfa [Measures on Litigation Fees] promulgated by the State Council, 19 December 2006, art 29; Interpretation on CPL, art 194.
[1091] Interpretation on CPL, art 207.
[1092] Liufang, 'A Study on Civil Litigation Fee, *Harvard Blog* <http://blogs.harvard.edu/guorui/files/2007/06/Litigationfee.pdf > accessed 29 April 2018.
[1093] ibid
[1094] Ye, 'Litigation in the People's Courts' in Moser (ed), *Managing Business Disputes in Today's China: Duelling with Dragons* (3 edn, Juris Publishing 2010) 176.
[1095] Stamford Law Corporation, *Mergers and Acquisitions in China* (Sweet & Maxwell Asia 2007) 319.

rarely decide to resort to the court to enforce their rights since even where the plaintiff succeeds in the court, the chances of collecting an award of damages are small, while litigation costs still need to be incurred with small probability of being refunded. The SPC tried to address this issue by adopting in 2010 the Several Provisions on Restricting High Consumption of Judgment Debtors,[1096] in which the natural person or the legal person[1097] who evades performing obligations determined in an effective legal judgment is subject to restriction of luxury consumption such as purchasing real estates and vehicles not necessary for business operations.[1098] Moreover, China adopts a directors' disqualification regime under which individuals who have big amounts of unsettled debt are prohibited from acting as company's directors, supervisors or senior officials.[1099] According to the White Paper on Judicial Reform, as of 2016 there were 71,000 individuals disqualified by the industrial and commercial administrations and market supervision authorities in China from holding the above-mentioned positions.[1100]

5.7.3. Effectiveness of Enforcement

The effectiveness of enforcement of directors' duties in the takeover context can be measured by two indicators: by how well it compensates shareholders for infringement of their rights[1101] and by its ability to deter managerial misconduct.[1102]

China's Company Law, Securities Law, the Takeover Measures and other regulations provide for relatively broad protection of rights and interests of shareholders both in general and in the context of takeovers specifically. Yet, enforcement of investors' rights remains a highly problematic issue. As a result, shareholders in China, in particular minority shareholders, often suffer financial damage from violation of their rights and interests for which they are usually not compensated.

Although public enforcement plays an important role in China it is not particularly effective in protecting the rights of minority shareholders. It may not

[1096] Zuigao Renmín Fayuan Guanyu Xianzhi Bei Zhixing Ren Gao Xiaofei de Ruogan Guiding [Several Provisions on Restricting High Consumption of Judgment Debtors] issued by the SPC, 20 October 2010 (Provisions on Restricting High Consumption).
[1097] In case of a legal person it also includes its legal representative, or key persons responsible for debt obligations.
[1098] Provisions on Restricting High Consumption, art 3.
[1099] CL arts 57 and 123.
[1100] Judicial Reform of Chinese Courts, White Paper, 27 February 2017 <http://www.chinadaily.com.cn/china/2017-02/27/content_28361584.htm> accessed 19 March 2018.
[1101] Chen, *A Comparative Study of Funding Shareholder Litigation* (Springer 2017).
[1102] Coffee Jr, 'Law and the Market: The Impact of Enforcement' (2007) 156 University of Pennsylvania Law Review 229.

be surprising, since the main body responsible for safeguarding these rights – the CSRC – is the subject of a serious conflict of interest in its dual role as primary market regulator and market promoter of listed companies.[1103] Most of the listed companies either have significant state ownership or are SOEs with the state as a controlling shareholder,[1104] therefore, the supervisory efforts of the CSRC are often tainted by political considerations. One should note that the CSRC derives its regulatory power in regards the securities market not from the law but from the State Council as the CSRC is not specifically named as the said authority under the Securities Law since Article 178 only mentions the 'security regulatory authority under the State Council'. It appears that the State Council could abolish the CSRC as a securities regulator anytime and install another body in its place. Charlie Weng even argues that the main responsibility of the CSRC is not to protect investors but to devotedly execute orders from the State Council. [1105] As a result, the CSRC may, for example, decide not to take actions against directors if it is the state that benefits from a transaction violating the rights of minority shareholders. A further impediment to an effective public enforcement is considerable constraints of resources and personnel faced by the enforcement bureau of the CSRC.[1106]

In theory, the fact that directors bear individual liability for breach of directors duties[1107] and joint and several liability for losses suffered by shareholders as a result of misrepresentation should prevent them from getting involved in activities violating shareholders rights. Combined with the rare use of D&O insurance for directors in Chinese listed firms,[1108] it should provide strong individual accountability of the board members. The deterrent effect, however, is not achieved partially because of the limited use of private enforcement by shareholders in China, which makes the likelihood of being caught and punished very low.

In order to address the issue of the courts' reluctance to accept complex cases, China has made continuous efforts into building the confidence of its judiciary. The recently established system of guiding cases containing, *inter alia*, cases related to securities and corporate disputes, helps to clarify the substantive law. Furthermore, in April 2018, based on the type and number of financial cases

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[1103] Gu (n1056) 291.
[1104] See pages 152-153.
[1105] Weng (n1025) 198.
[1106] Gu (n1056) 291.
[1107] CL, art 149.
[1108] Only approximately 10% of firms listed on China's domestic exchanges provide D&O insurance to their directors. AIG, 'Why Do Chinese Companies Need a D&O Policy?' (03 June 2017) <https://www.aig.com/content/dam/aig/america-canada/us/documents/insights/why-chinese-firms-need-a-d.o-policy-d.o-whitepaper-20170306.pdf> accessed 17 May 2018.

tried so far, China decided to establish the first Financial Court responsible for the adjudication of financial and commercial civil and administrative cases.[1109] The concept of a financial court in Shanghai had been proposed for almost ten years[1110] and was in line with the SPC's recent policy document – Some Opinions Concerning the Further Strengthening of Financial Trial Work"[1111] (Opinions on Financial Trial Work) issued to further enhance the professionalisation and specialisation of Chinese courts, pursuant to which the courts that handle many financial and commercial cases should establish a special financial division dedicated solely to resolving these kinds of disputes.

In addition, similar problems as in case of public enforcement arising from extensive state ownership in listed companies are also present in private enforcement. Balancing the interests of the state against the enforcement of private rights is often considered by many judges, influenced by political connections, to be an essential part of their role.[1112] Prevalent lack of transparency in the judicial process in China allows the judges to hold private meetings with the parties to a dispute,[1113] what in turn affords a local party, often a defendant with better networks, a bigger chance of winning the case.[1114] It is also a common practice by the local governments to pressure local courts to delay or deny an outsider's application, or even to decide a case in favour of the company incorporated in a given region.[1115] In light of the above, Peerenboom explains that local protectionism in China is a matter of degree: it either impedes or is an absolute bar to shareholders' recovery.[1116] All of the above deter shareholders from initiating suits since directors are likely to benefit from local connections.

To address the problem of inadequate investor protection and to increase use of private actions by shareholders, China is considering the possibility of designating a specialised institution to sue on behalf of shareholders.[1117] In the meantime, in December 2014 China established the Securities Small and

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[1109] Quanguo Renmin Daibiao Dahui Changwu Weiyuanhui Guanyu Sheli Shanghai Jinrong Fayuan de Jueding [Decision Concerning the Establishment of Shanghai Financial Court] promulgated by the NPC, 27 April 2018.
[1110] Finder, Some Quick Thoughts on Shanghai's Financial Court available (*Supreme People's Court Monitor*, 29 April 2018) <https://supremepeoplescourtmonitor.com/tag/shanghai-financial-court/> accessed 30 May 2018.
[1111] Guanyu Jinyibu Jiaqiang Jinrong Shenpan Gongzuo de Ruogan Yijian [Notice on Issuing the Several Opinions on Further Strengthening Financial Trials] issued by the SPC 04 August 2017.
[1112] Stamford Law Corporation (n1095) 318.
[1113] ibid 318.
[1114] ibid 318.
[1115] Peerenboom, 'Judicial Independence in China: Common Myths and Unfounded Assumptions' (2008) 11 La Trobe Law School Legal Studies Research Paper, 82-83.
[1116] ibid 82-83.
[1117] Huang, 'What Shapes…' (n1050)

Medium Investors Service Centre (ISC), a non-profit organization under direct management of the CSRC intended to provide support services for the investors.[1118] The ISC has already launched a program which helps shareholders to litigate. [1119] Several securities lawsuits have been initiated with the assistance of the ISC, which publicly solicited small and medium investors whose interests were damaged by misleading statements of the named companies to join the lawsuit. Moreover, in order to deal with partiality and corruption in the adjudication of cases, China introduced a series of measures aiming to improve process transparency, for example, certain judgements including corporate and securities cases have to be published online at the designated website pursuant to the Provisions on the Publication of Judgment Documents.[1120] These efforts are likely not only to increase the efficiency of the legal process but also may result in a more generous amount of compensation awarded to shareholders generally and in a takeover context.

5.8. Conclusions

China's approach to regulating corporate governance of its public companies is characterised by shareholder primacy, at least on the books. It is partially reflected in the takeover context since, once the tender offer is launched, the board is generally not allowed to 'improperly' obstruct shareholders' decision to sell their shares. The provisions of the takeover regime regulating directors duties are very general and rather ambiguous in China, therefore, the board's exact position is relation to anti-takeover measures is not entirely clear.

Although the legitimacy of pre-bid defences remains unresolved, the empirical evidence shows that many, if not the majority of, listed companies include such measures in their articles. While Article 8 of the Takeover Measures does not seem to require the directors to completely avoid anti-takeover mechanisms, pursuant to Article 33 after the bid has been announced actions which would involve exerting major impact on the company are prohibited without shareholder approval. Article 33, however, does not stipulate that the general meeting must approve a specific defensive measure, what potentially allows directors to secure a blank cheque permission to adopt defences for a specified period of time.

[1118] ISC website, < http://www.isc.com.cn/about_us/.> accessed 18 May 2018.
[1119] Tou Fu Zhongxin Qidong Di Si Li Zhengquan Zhichi Susong [The Fourth Case of ISC-supported Securities Litigation Launched] (27 April 2017) <www.isc.com.cn/about_us/dsj/2017/201706/t20170627_194143.shtml> accessed 18 May 2018.
[1120] Zuigao Renmin Fayuan Guanyu Renmin Fayuan zai Hulianwang Gongbu Caipan Wenshu de Guiding) [Provisions on the Publication of Judgment Documents] issued by the SPC, 29 August 2016, art 3.

One of the areas of concern of the existing takeover regime involving directors' role is linked to the identity of the main beneficiary of their fiduciary obligations as, although the Company Law provides that directors owe their duties to the company, under the Takeover Measures directors duties are towards both the company and its shareholders. It is unclear whose interests should take preference in case of conflicting interests.

Shareholders are generally well protected by the Takeover Measures, however, application and enforcement of their provisions by the securities regulator remain rather weak. Despite the requirement of launching the tender offer to all shareholders when a certain threshold of ownership is crossed, the CSRC often grants exemptions from the mandatory bid rule, especially when a transaction involves an SOE. Administrative intervention in takeovers has been gradually removed and now the acquirer does not need to be vetted by the CSRC before launching the offer, which weaken the protection afforded to the shareholders. Combined with a poor private enforcement of takeover regulations, yet another area of concern of the existing takeover regime i.e. inadequate protection of minority shareholders is exposed.

CHAPTER VI Comparative Analysis between the US, the UK and China

6.1. Primary Challenges Faced by Listed Companies

The comparative analysis begins by exploring the primary challenges and concerns faced by each jurisdiction and whether the market for corporate control is able to address them. Since corporate ownership structure is one of the main determinants of agency costs,[1121] the problems experienced by the companies in the US and the UK which have traditionally been characterised by dispersed ownership are likely to differ from those experienced by the companies in China with highly concentrated ownership.

Shares of the US and the UK' companies are generally held by a great number of shareholders many of whom own only a small fraction of the company's equity with typically no single controlling shareholder owning adequate voting control. Chinese companies are often controlled by a single shareholder or a group of shareholders.[1122] Whilst as many as 72.2% of China's listed firms have a controlling shareholder, only 28.4% of the US and 20.6% of the UK firms are considered to be controlled.[1123] The largest shareholder (and the top five shareholders) of firms incorporated in China, the US and the UK owns on average 37.1%, 21.4% and 19.5% (50.3%, 33.9% and 37.1%) of the firm's issued shares respectively.[1124] This means that a few large shareholders in China hold a legal control in the majority of China's listed firms which gives them a possibility to dominate other investors.

Based on the identity of the ultimate dominant shareholder, listed companies in China can be categorised as central state-controlled, local state-controlled and non-state-controlled (privately controlled).[1125] The extensiveness of state control as well as its prevalent presence in the corporate structures of listed companies is what differences China the most from the other analysed jurisdictions. The

[1121] See eg Ang, Cole and Lin, 'Agency Costs and Ownership Structure' (2000) 55 the Journal of Finance 81(reporting that agency costs increase with the number of non-manager shareholders); Morck, Shleifer and Vishny, 'Management Ownership and Market Valuation: An Empirical Analysis' (1988) 20 Journal of financial economics 293 (claiming that company's assets may be deployed to benefit managers when the shareholders are too dispersed to enforce value maximization); Shleifer and Vishny, 'Large Shareholders and Corporate Control' (1986) 94 Journal of political economy 461 (providing evidence that the controlling owner can expropriate private benefits at the expense of other shareholders); Thomsen and Pedersen, 'Ownership Structure and Economic Performance in the Largest European Companies' (2000) 21 Strategic Management Journal 689 (reporting that the ownership above a certain level may lead to entrenchment of owner-managers that expropriate the wealth of minority shareholders).

[1122] Aminadav and Papaioannou, 'Corporate Control Around the World' ('Dynamics of Inclusive Prosperity' Conference, Rotterdam November 2018).

[1123] Controlled firms are those with a controlling shareholder (state, family, other) who either has more than 20% of the voting rights or is identified using a game-theoretic method based on the voting power index. See ibid 2-3.

[1124] ibid

[1125] Leung and Cheng, 'Corporate Governance and Firm Value: Evidence from Chinese State-Controlled Listed Firms' (2013) 6 China Journal of Accounting Research 89 89.

percentage of the state as an ultimate shareholder in China's listed firms is as high as 63.15%,[1126] with 23.2% of the listed firms being directly controlled by the state.[1127] The figure is significantly smaller in the US and the UK – only 0.2% and 0.9% of the listed firms respectively remain under direct control of the state.[1128]

Thus, challenges faced by the corporate regimes of the US and the UK mostly revolve around the risk of opportunism of executive directors vis-à-vis shareholders (type I agency cost), while opportunism of controlling shareholders vis-à-vis minority shareholders (type II agency cost) is the main concern of Chinese regime. It is, of course, not implied that the other type of agency problems does not exist in the respective jurisdictions. In China the risk of managerial opportunism is also present, and it should be accounted for accordingly.

The opportunism of controlling shareholders can be realised through expropriation of minority shareholders or promotion of the objective of the controllers at their expense.[1129] This may occur via tunnelling value away from the company through related-party transactions, fund misappropriation, inter-companies loans and the likes.[1130] The tunnelling activities in China are strongly connected to the identity of the controlling shareholder.[1131] Whilst SOEs in general tend to extract more private benefits of control than privately controlled firms,[1132] local SOEs engage more frequently in tunnelling activities than central SOEs.[1133] Local governments often use listed firms to subsidise public expenditure or to provide retirement benefits to former employees at the expense of minority shareholders.[1134] The outlined differences can be partially explained by different corporate governance arrangements adopted. Central government, as the ultimate controller, has less incentive to expropriate profits. Since the state is rarely a direct shareholder, it tends to supervise the firms it controls more strictly, imposing restrictions on the activities of the largest shareholders.[1135]

[1126] Li and Zhang, 'Corporate Social Responsibility, Ownership Structure, and Political Interference: Evidence from China' (2010) 96 Journal of business ethics 631.
[1127] Aminadav and Papaioannou (n1122) Table 1.
[1128] ibid
[1129] Porta and others, 'Law and Finance' (1998) 106 Journal of political economy 1113.
[1130] ibid
[1131] Leung and Cheng (n1125) 108.
[1132] Ding, Zhang and Zhang, 'Private Vs State Ownership and Earnings Management: Evidence from Chinese Listed Companies' (2007) 15 Corporate Governance: An International Review 223.
[1133] Leung and Cheng (n1125).
[1134] Which is one of the reasons why such firms are often subject to the local protectionism.
[1135] Leung and Cheng (n1125) 93.

Apart from the degree of the ownership concentration and the identity of the controlling shareholder, the characteristics of shareholders is another very important feature that influences challenges the firms are likely to face. The UK's capital markets have been traditionally dominated by institutional investors[1136] who are often considered organised, competent, involved[1137] and capable of making informed decisions.[1138] Although the ownership of the US firms has traditionally been in the hands of retail investors, what often resulted in collective action problems and rational apathy among the shareholders,[1139] the presence of institutional investors has increased significantly over the years.[1140] Nowadays, institutional investors hold approximately 85% and 70% of the equity of all publicly traded companies in the UK[1141] and the US[1142] respectively. It is also very common for institutions in both the UK and the US to hold larger concentrated blocks of shares of 5% or more of a listed firm's issued shares,[1143] which provides them with enough incentives to collect and analyse information to make informed choices and to avoid collective action problems. Similarly to their UK counterparts, institutional investors in the US are well-informed and more actively pursue through voting their interests.[1144] According to Gilson and Gordon,[1145] today's US shareholders, rather than being rationally apathetic are 'rationally reticent' – that is, they are unlikely to initiate, but will usually respond to measures proposed by the activist investors. Therefore, while collective action problems and lack of incentives to monitor may and still exist in the UK and the US, their scale have been significantly diminished. Moreover, in change of control transactions, institutional shareholders have even greater incentives to analyse available relevant information in order to determinate whether the offer is beneficial.[1146] In China's

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[1136] Such as pension funds, insurance companies, hedge funds and mutual funds (straightforward profit maximising joint stock companies), private equity firms. Davies and Davies, *Introduction to Company Law* (Oxford University Press 2010) 57; Office of National Statistics, 'Ownership of UK Quoted Shares 2016.' (Statistical Bulletin, 29 November 2017) <https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2015-09-02> accessed 02 March 2018.

[1137] However, according to Armour and Skeel Jr (n442) 1770 the UK institutional investors remain rather passive regarding the performance of individual firms.

[1138] Ventoruzzo, 'Takeover Regulation as a Wolf in Sheep's Clothing: Taking Uk Rules to Continental Europe' (2008) 11 University of Pennsylvania Journal of Business Law 135, 141.

[1139] Kershaw, *Company Law…* (n170) 180.

[1140] The institutional shareholders of today's US corporations are mainly intermediaries such as mutual funds and hedge funds. Gilson and Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights' (2013) 113 Columbia Law Review 863.

[1141] 'Ownership of UK Quoted Shares 2016' (n1125).

[1142] Tonello and Rabimov, *The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition. The Conference Board Research Report* (2010).

[1143] Aminadav and Papaioannou (n1122), Table 1.

[1144] For an example of shareholders activism see page 30.

[1145] Gilson and Gordon (n1140).

[1146] Davies and others (n493) 709.

young capital markets, on the other hand, almost half of all shares are held by individual retail investors[1147] who are generally considered uninformed and rationally apathetic, thus collective action problems and lack of incentives to monitor are widespread and therefore pose many challenges in China, the biggest of which is the possibility for controlling shareholders to extract private benefits. It should be noted that recent boardroom battles such as those between Minsheng Bank and Anbang Insurance Group in 2014[1148], CSG Holding and Baoneng Group in 2016[1149] and China Vanke and Baoneng Group in 2016-2017[1150] may indicate the beginning of arrival of the activist investors to China. Yet, given the reaction of the state, when Shiyu Liu, the then CSRC's chairman, called the insurance firms who attempted proxy fights 'evil monsters', 'barbarians' and 'poisonous demons'[1151] it is too early to judge whether and how shareholder activism will develop in China.

The conflict of executive directors vis-à-vis shareholders also exists in China, but often, especially in case of SOEs and firms with significant state ownership, it differs from the type I agency problem common in the US and the UK due to distinctive corporate governance arrangements adopted in China. In the Anglo-American system, where a separation of ownership and control is a longstanding phenomenon, the professional executives managing firms have economic incentives that cause them to shirk their duties at the expense of shareholders.[1152] Executives' incentives in China are more political in nature.[1153] In SOEs and firms with a significant state influence, directors' appointments are often prompted by the bureaucratic system rather than being based on experience and expertise of the candidates.[1154] In light of the above, directors are often considered to be the part of the political elite with an aspiration to climb the ladder of state organisational hierarchy.[1155] Instead of fully focusing on maximisation of the firm's value, the bureaucratic executives commonly focus on strengthening their political connections by serving those who have helped or

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[1147] Wong, 'Corporate Governance Research on Listed Firms in China: Institutions, Governance and Accountability' (2016) 9 Foundations and Trends in Accounting 259.
[1148] Ding, 'The Role of Institutional Shareholder Activism in Corporate Governance: A Comparative Study of the Uk and Us and China' (Doctoral dissertation, University of Glasgow 2018).
[1149] Wildau, 'China Corporate Raider Baoneng in New Boardroom Battle' *Financial Times* (20 November 2016) <https://www.ft.com/content/a5075406-ad59-11e6-9cb3-bb8207902122> accessed 3 June 2018.
[1150] Kruszewska, 'Target Board's …' (n931).
[1151] Tang, 'China's muddled regulatory battlefront against stock market "monsters"' *South China Morning Post* (11 December 2016) < https://www.scmp.com/news/china/economy/article/2053563/battling-beasts-black-stock-market-lagoon> accessed 18 March 2018.
[1152] See Part 1.5.2.
[1153] Wong (n1147) 275.
[1154] ibid 275; Howson and Clarke (n767) 244.
[1155] Wong (n1147) 275.

can help them with career advancement, often at the expense of the company and its shareholders. Executives in China are also relatively likely to accept illegal income, such as bribes or kickbacks, in exchange for business-related favours. The Corruption Perception Index[1156] places China in 77th position of the least corrupt countries in the world, while the US and the UK are each placed in 8th and 16th positions respectively. Another example of executives' opportunism in China is the practice of extracting private benefits through perquisites, expense accounts and side payments.[1157] Because of the significant disparities in remuneration levels across state firms in China, the government in 2009 capped executive remuneration in SOEs at the ratio of 20 times the average employee compensation.[1158] In comparison, the avarage CEO to employee remuneration ratio in the UK is currently 137 to 1,[1159] whilst the US ratio of 312 to 1[1160] is even higher. It appears that China failed to adopt a policy of using executive's remuneration as a mechanism designed to align managerial interests with those of the shareholders. In order to fulfil this aim, remuneration of executive directors in both the US and the UK is typically tied to the firm's performance, whilst in China such direct connection typically does not exist.[1161] Moreover, in comparison with the two jurisdictions, the magnitude of executive shareholdings in China is still at negligible level, especially in SOEs in which such holdings remain below 1%.[1162] Equity-based remuneration such as stock options was not permitted in China until 2006.[1163] Although nowadays allowed, the equity component still constitutes only a small fraction of executive pay,[1164] especially when compared with the US and the UK.[1165] Since executives of the SOEs are not able to receive higher remuneration even if their firm performs well, they are indirectly provided with incentives for extracting private benefits, which is likely

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[1156] Transparency International, 'Corruption Perceptions Index 2017' (21 February 2018) <https://www.transparency.org/news/feature/corruption_perceptions_index_2017> accessed 20 July 2018.
[1157] Milhaupt and Zheng, 'Why Mixed-Ownership Reforms Cannot Fix China's State Sector' (2016) 5 Paulson Policy Memorandum, 8.
[1158] Bae, Gong and Tong, 'Restricting Ceo Pay Backfires: Evidence from China'. <https://www.ssrn.com/abstract=3081822> accessed 10 April 2019.
[1159] Chartered Institute of Personnel and Development, 'Executive Pay: Review of FTSE 100 Executive Pay' (August 2018) <https://www.cipd.co.uk/Images/2018-review-ftse100-exec-pay_tcm18-45480.pdf> accessed 10 October 2018.
[1160] Economic Policy Institute, 'CEO Compensation Surged in 2017' (16 August 2018) <https://www.epi.org/files/pdf/152123.pdf> accessed 10 October 2018.
[1161] Conyon and He, 'Executive Compensation and Corporate Governance in China' in Thomas and Hill (eds), *Research Handbook on Executive Pay* (Edward Elgar 2012).
[1162] Firth, Leung and Rui, 'Executive Compensation and Corporate Governance in China' in Thomas and Hill (eds), *Research Handbook on Executive Pay* (Edward Elgar 2012) 395.
[1163] Conyon and He (n1161).
[1164] Firth, Leung and Rui (n1162); Conyon and He (n1161).
[1165] Mishel and Schieder, 'Ceo Compensation Surged in 2017' (2018) 16 Economic Policy Institute; 'Executive Pay…' (n1159).

to increase type I agency costs in state-owned companies. Bae, Gong, and Tong's empirical study supports this observation.[1166]

The existence of type I agency problems in China may seem surprising since the majority of firms have a controlling shareholder which is often believed to have enough incentives to monitor the executives. Similarly to type II agency problems, severity of type I agency problems also seem to be linked to the identity of the dominant shareholders with the local SOEs suffering from more acute problems than central SOEs and non-state companies. This is likely to be the result of the 'grasp the large, release the small' policy[1167] which decentralised ownership in majority of the SOEs to local governments leaving only the most important firms under the control of central government. China's system of state enterprise management, especially at the local level, often consists of many layers between the ownership agency SASAC and the SOEs what means that the state's controlling stake is usually not directly held by the SASAC. The most common form involves three levels, with the firm at the base level, an investment or holding company in the middle, and the local SASAC at the top.[1168] Such a system often results in loss of undisrupted information flow and lack of close monitoring which contribute to type I agency problems. Furthermore, the fact that executives of privately-owned companies hold a significantly higher stake, often a controlling one,[1169] may be one of the reasons why the type I agency problem is not as severe in non-state firms as in the SOEs.

6.2. Defensive Responses to Hostile Takeovers

The takeover regimes of the US and the UK differ substantially, particularly in their approach to director's conduct and the use of anti-takeover measures. The US adopted 'the board discretion rule' which generally allows the use of defensive tactics by the target board, subject to fiduciary obligations and judicial review, while the Takeover Code governing M&A activities in the UK follows 'the board neutrality rule' that minimises the board's involvement in takeovers and prohibits the use of takeover defences, unless such conduct is approved by the shareholders of the target firm.

Despite, or perhaps, because of the fact that the provisions regulating director's conduct in a takeover context have been transplanted from both the UK (and Hong Kong) and the US laws, the position and the role of the board in China in

[1166] Bae, Gong and Tong (n1158).
[1167] See page 105.
[1168] Naughton, 'Top-Down Control: SASAC and the Persistence of State Ownership in China' 2006 ('China and the World Economy' Conference, Nottingham June 2006) 6.
[1169] Firth, Leung and Rui (n1162) 404.

the context of a hostile takeover remain unclear under existing regulations, which constitutes one of the main areas of concern of the existing regime. Simultaneous adoption of seemingly contradicting rules within one system[1170] will inevitably account for the source of general confusion, hence the unresolved discussion among the scholars researching China's takeover regulations[1171] as to whether or not China permits the use of defensive mechanisms and what kinds of tactics, if any, are allowed.

6.2.1. Post-bid Defences

When faced with an official tender offer, directors in all three jurisdictions must provide their opinions on the bid and recommendation whether or not to accept it. The target board in China has the longest statutory time for preparation of its response to the presented offer (20 days), followed by the UK (14 days) and the US (10 days). A recent change to the UK's Takeover Code provides in practice for a longer response time (additional 14 days), as the bidder is allowed to publish offer document within 14 days after the announcement of its firm intention to make an offer only with the consent of the target board, which it is very unlikely to obtain in case of a hostile acquisition. The time available to the board to prepare its response to the takeover offer is particularly important in jurisdictions with strict no-frustration rule since it is the most important part of the board's defence strategy.

Directors in the UK are not allowed to engage in any activities frustrating shareholders' right to decide whether or not to accept the offer in a way other than soliciting shareholders' votes or third parties in order to find alternative bids, regardless of their good faith and the purpose of the frustrating action. The board neutrality rule is the reflection of the UK's company law which adopts a strong shareholder-oriented approach, with certain decision rights as its fundamental norm. It is even argued that the strict requirement of non-frustration is trivial given the fact that the company law requires the general meeting to approve transitions needed to adopt many of the post-bid takeover defences.[1172] Since, the institutional shareholders who constitute the majority of investors in the UK's capital market remain rather hostile towards the anti-takeover measures,[1173] it is highly unlikely that the boards of directors would be able to deploy defences limiting or denying target shareholders the opportunity to

[1170] Article 8 of TM appears to be based on the US board discretion rule, while Article 33 resembles the UK's (and Hong Kong's) neutrality rule.
[1171] See pages 116 - 117.
[1172] Kershaw (n445) 352.
[1173] See page 75.

decide on a takeover, even in the absence of Rule 21.1 of the Takeover Code. The triviality argument is further supported by the analysis showing that a similar substantive effect of non-frustration would be achieved by application of the proper purpose doctrine (codified as one of director's duties in Section 171 of the CA 2006) by the courts.[1174] This is also the case in Hong Kong that transplanted its takeover regulation from the UK. In addition to adopting strict board neutrality rule, which is almost identical to the provision of Rule 21.1 of the Takeover Code,[1175] Hong Kong modelled its company law on the UK's law giving extensive control rights (such as approval rights of shares issuance or a sale of substantive assets) to the shareholders.[1176] Given highly concentrated shareholder structures of Hong Kong companies, the requirement of non-frustration does very little there to alter the dynamics in the context of a hostile takeover, and, as noted by Varottil and Wan, 'can at best be described to be a policy statement of sorts'.[1177]

Similarly, in the US the ultimate decision whether or not to accept the bid is in the hands of shareholders, but it is often up to the board whether the shareholders will be presented with the opportunity to decide. It appears that the target board of the US firm is entitled to *just say no* to any bid it finds inadequate based on the claims of substantive coercion risk.[1178] The US's company law seems to assume that shareholders face issues such as rational apathy which may impede their ability to make an informed choice, and therefore in some circumstances they may require protection against certain type of decision-making activities. Therefore, directors in the US have a broad range of post-bid defences that they can employ to prevent shareholders from deciding on takeovers. The use of anti-takeover measures is subject to a judicial review of directors' fiduciary duties. Some of the measures which tend to openly damage the interests of the firm e.g. a crown jewel defence are more likely to attract closer scrutiny. Moreover, in *Airgas* the court explained that despite the broad discretion, the board has no right to *just say never* meaning that directors can oppose the bid and obstruct shareholders' choice only until the latter decide to replace an incumbent board with new directors who will provide shareholders with the opportunity to vote

[1174] See analysis at pages 67 - 67; also see Kershaw (n445) 110 and 324.
[1175] The Codes on Takeovers and Mergers and Share Repurchases, 2018, r 4: 'Once a bona fide offer has been communicated to the board of an offeree company or the board of an offeree company has reason to believe that a bona fide offer may be imminent, no action which could effectively result in an offer being frustrated, or in the shareholders of the offeree company being denied an opportunity to decide on the merits of an offer, shall be taken by the board of the offeree company in relation to the affairs of the company without the approval of the shareholders of the offeree company in general meeting (…).'
[1176] Varottil and Wan (n21) 26-28.
[1177] Ibid 26.
[1178] See Part 2.5.2.1.

on the offer. In theory, Delaware law thus offers enhanced protection of shareholders' democracy under the *Blasius* standard.[1179] The board cannot frustrate the shareholders' franchise manifested through directors elections if the primary purpose of doing so is impeding the effective exercise of a shareholder vote.[1180] In practice however, the various standards of review which were supposed to assist the courts to assess adoption of defensive measures are no longer particularly meaningful. The allocation of decision making has in practice been moved almost entirely to the target board, since that board can obstruct shareholders' choice so long as it is not mathematically impossible or realistically unattainable to replace the board in a proxy fight with members who would allow the hostile acquisition to succeed.[1181]

In China's takeover regime the ultimate decision-makers are also the shareholders. Although it may be argued that Article 8 of the Takeover Measures provides the board with some discretion in relation to post-bid defences, the company law, by making shareholders a powerful organ of governance, nevertheless puts a substantial restriction on the range of anti-takeover tactics the board can lawfully introduce if it does not have shareholder support. Despite ostensibly limited space for defensive manoeuvres due to adoption of 'relaxed' board neutrality rule, the board can still delay the unwanted takeover or even stop it altogether by lobbying the authorities or taking advantage of provisions of other regulations. Merger control, with its pre-merger notification requirement, public interest test and quite extensive room for state intervention, provides a good example of how other regulations can be used by the board to frustrate the bid.[1182] The shareholders can, however, replace the incumbent board if they are dissatisfied with its conduct, yet some minor loopholes of the current corporate regime[1183] allow this right to be effectively sabotaged by directors' resistance. Such a possibility is well illustrated by the widely reported takeover battle between Vanke and Baoneng, where Vanke's board first rejected the proposal of the biggest shareholder to call for an extraordinary meeting to replace directors and then months later to thwart Baoneng's vote it arbitrarily delayed the AGM during which the new board was supposed to be elected, skilfully choosing the date of announcement to interfere with Baoneng's right to nominate the candidates to the board.[1184] In the US and in the UK, such conduct most likely would not pass the test under the *Blasius* standard and a duty to act

[1179] See pages 38 - 39.
[1180] ibid
[1181] Gilson (n336) 500-1.
[1182] See Part 5.5.1.2.
[1183] See Part 5.4.
[1184] Kruszewska, 'Target Board's …' (n931).

for proper purposes under Section 171 of CA 2006 respectively. Admittedly, it can be argued that such an action constituted an 'abuse of directors' power' and created an 'improper barrier' to a takeover under Article 8 of the Takeover Measures. As discussed in Part 5.5.1, these two concepts are not further explained, and, therefore, remain unclear. Yet, it is possible that a standard requiring directors not to create improper obstacles by abusing their powers may have been inspired by the UK's proper purpose doctrine and could be interpreted as such, but there is no evidence to support this thesis. Nevertheless, despite these ambiguities, if the law in the books was enforced diligently, directors in China would generally not be able to enjoy a very broad discretion in employing defensive tactics, especially given concentrated ownership structure of the majority of Chinese companies.

An important difference between the UK's Rule 21.1 of the Takeover Code (and Hong Kong's Rule 4 of the HK Code) and China's regulation of directors' conduct by Article 33 of the Takeover Measures is the fact that UK's and Hong Kong's strict neutrality rules apply not only after the launch of a tender offer, but also from the time the target board has reason to believe that a bona fide bid might be imminent. In China, however, the target board is prohibited from adopting certain actions which may frustrate the takeover only after the announcement of takeover offer by the acquirer. By mandating that the sensitive period begins as soon as the target board believes that an offer might be imminent both the Takeover Code and the HK Code guard against the situation where directors are left with a possibility to adopt frustrating strategies within the window period when the board knows of the acquirer's potential intention to make the bid and when the announcement of the takeover offer is actually made, which is the case under China's Takeover Measures. Whereas earliest starting point of the board neutrality requirement in the UK provided for in the first version of the Takeover Code began when the offer *was* imminent, in the current version it starts from when the board believes that the offer *might* be imminent which extends the period of the neutrality rule and effectively limits the board's ability to defend against a specific takeover attempt.

Among very few lawful methods available to the board in the UK to frustrate the existing bid, apart from lobbying authorities, recommending shareholders to reject the offer and soliciting their votes, is to seek a competing bidder on the basis of a negative evaluation of the offer. The board cannot, however, obstruct the choice of shareholders by favouring one bidder over another, thus all information supplied to any other potential acquirer must be also provided to the

unwelcome one upon request. The board is not even allowed to afford the favoured bidder a potent protection against the competing bids since break-up fees and other deal protection measures (DPMs) are prohibited without the consent of the Panel.[1185] The Panel typically permits an inducement fee of no more than 1% of the value of the transaction when the original bid has not been recommended by the board.[1186] In the US directors are permitted to protect a friendly deal or a deal with the white knight against potential competing transactions by the use of DPMs, subject to enhanced judicial scrutiny.[1187] Devices employed by the board will typically be reviewed using the *Unocal* test: first, the board must have reasonable grounds to believe that there is a threat to the firm and second, the measures adopted must be reasonable in relation to a threat.[1188] The third-party bid or the possibility of losing the existing offer and being left with no comparable alternative deal may constitute a threat.[1189] The Delaware Court assesses the reasonableness of DPMs on a case by case basis, for example the break-up fees of up to 6% of the equity value were considered within a reasonable range,[1190] although most commonly such fees are within the range of 3-4%.[1191] Similarly to the US, directors in China are also allowed to protect a specific deal by employing DPMs as long as they are fair and reasonable.[1192] There is currently no bright-line rule in China regulating the use of such mechanisms, however, an inclusion of excessively high break-up fees in the merger agreement might be rejected by the court on the basis for a breach of fiduciary duty claim. Availability of the DPMs may prove useful in a hostile takeover context, especially given the fact that the target board may relatively easily delay the hostile bid to secure some time to search for a suitable white knight. Although all bidders must be treated fairly, the concept of the fair treatment is not further specified,[1193] what together with the possibility of employing the DPMs may provide for a relatively powerful defence.

[1185] TC, r21.2.
[1186] TC, r21.2(note 1).
[1187] Saulsbury IV, 'The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies' (2012) 37 Delaware Journal of Corporate Law 115.
[1188] Eg *Omnicare, Inc. v NCS Healthcare, Inc.,* 818 A.2d 914 (Del. 2003) 930-33.
[1189] ibid 935.
[1190] Eg *Re Answers Corp. Sholders Litig*., 2011 WL 1366780 (Del. Ch. Apr. 11, 2011) 9 (calling a termination fee of 4.4% of equity value near the upper end of a conventionally accepted range); *Re Comverge, Inc. Sholders Litig.,* CA No 7368-VCP, 2014 WL 6686570 (Del. Ch. Nov. 25, 2014) 15-17 (calling a termination fee of 5.5% of equity value as testing the limits of what this Court has found to be within a reasonable range for termination fees).
[1191] Officer, 'Termination Fees in Mergers and Acquisitions' (2003) 69 Journal of Financial economics 431.
[1192] International Financial Law Review, '2015 Mergers and Acquisitions Report: China' (26 March 2015) <http://www.iflr.com/Article/3439975/2015-Mergers-and-Acquisitions-Report-China.html> accessed 17 February 2018.
[1193] ibid

Tactical litigation is rarely used as a defensive measure in both the UK and the US although the reasons behind such states in the two jurisdictions are strikingly different. The lack of post-bid litigation in the UK can be explained by strict board neutrality rule. Whilst the target board of directors has no right of action against the acquirer breaching provisions of the Takeover Code,[1194] the Panel and the courts expressed their hesitance to allow any litigation during the takeover bid and encouraged parties to a takeover to first approach the Panel before commencing any action which may affect the success of the offer.[1195] In the US, on the other hand, tactical litigation is rarely commenced by the target board simply because there is no need to do so. The board of a US' company is equipped with a range of other, non-litigious, defences which can be used to affect the outcome of a transaction.[1196] It appears that directors of Chinese targets can easily initiate tactical litigation as there is no formal restriction on them to do so. Such decision would be, however, subject to director's duties under Article 8 and 33 of the Takeover Measures. In 2017 in the middle of Vanke v Baoneng takeover battle,[1197] the target filed a lawsuit accusing Baoneng[1198] of not fulfilling disclosure obligations in accordance with requirements of the Securities Law and the Takeover Measures. The plaintiff petitioned for invalidation of the share purchase by Baoneng as well as for imposing a limit on its rights as a shareholder including e.g. proposal and voting rights until the action was corrected.[1199] The target's attempt to use the court to disturb the unwelcome creeping acquisition by Baoneng was nonetheless unsuccessful.

6.2.2. Pre-bid Defences

The use of pre-bid defences is widely associated with a country's company law and its corporate governance arrangements. Outside of the bidding period, the boards in analysed jurisdictions are equipped with a different level of discretion in relation to the adoption of anti-takeover tactics. Delaware law allows the board to adopt a range of measures to deter the potential hostile acquirers. The courts typically afford more deferential treatment to reasonable anti-takeover measures constructed on a 'clear day' i.e. before the start of a contest for control. The UK's neutrality rule binds directors only when they believe the offer might be imminent, which means that in theory the board is allowed to adopt certain

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[1194] See page 77.
[1195] Morley, 'Takeover Litigation: The Us Does It More Than the Uk, but Why and Does It Matter?' (2017).
[1196] Armour and Skeel Jr (n442).
[1197] No tender offer had been made at that point.
[1198] Wanke Gonghui v Ju Sheng Hua [Vanke Labour Union v Yan Shenghua] Luohu District People's Court of Shenzhen Municipality, 2016, No 318.
[1199] ibid

pre-bid defences, subject to fiduciary duties and other laws. Contrary to the US, the courts in the UK would most likely not tolerate 'poison pill' defences adopted on a 'clear day' before any real and present threat to the company exists. Although certain defensive measures could in theory be validly taken in the UK, the power afforded to the shareholders makes them largely ineffective in entrenching the target board. For example, the staggered board common in the US, is not prohibited in the UK either, but the fact that directors in many of the listed firms are elected annually, as well as the possibility of removal without cause at any time by a simple majority, lowers the effectiveness of such measure almost to zero. In China, on the other hand, staggered boards are neither explicitly prohibited nor permitted and many listed firms include such measures in their articles. Outside of the bidding period the boards of Chinese firms enjoy relatively broad discretion in fulfilling their duties even if doing so would frustrate an upcoming bid as long as the decision taken and the measures implemented are beneficial for the company and its shareholders and are carried out in accordance with law. This seems to resemble the US 'clear day' rule.

Although shareholder rights plans are allowed and very common in the US,[1200] pressure from the activist shareholders in the recent years caused many firms to dismantle their anti-takeover measures, and this was acutely the case with the poison pill. It would also appear that the campaigns of shareholder activism have prompted directors to became more responsive to shareholders' demands. Hostility of institutional investors towards such measures has also been one of the main reasons why adoption of the US-style poison pill in the UK is not particularly feasible.[1201] In an unlikely event when the board manages to successfully put a shareholder rights plan in place, the Takeover Code's neutrality rule would require the board to redeem it once there might be an imminent bid on the horizon.[1202] Similarly as in case of material change of control clauses, although in theory available, golden parachutes in the UK carry some risk of breach of fiduciary duties and is subject to extensive disclosure and shareholders' approval, therefore, are rarely used in practice to discourage potential takeovers.[1203] Despite recent attempts to curb the use of excessive golden parachutes, they are still alive and well in the US.[1204] Although the US-style poison pill, if introduced skilfully, may not be unlawful in China, its use

[1200] The right to use poison pill is, however, not absolute – the company's board should have the ability to redeem it when eg the new board of directors is elected (no dead-hand pills allowed) or when the break-up of the firm is inevitable (when the firm is in the *Revlon* mode).
[1201] For discussion of other reasons see pages 73 - 75.
[1202] ibid
[1203] See Part 3.5.4.2.
[1204] See Part 2.5.1.2.

by Chinese firms is extremely limited.[1205] A viable reason for unpopularity of a poison pill in China may be linked to procedural matters related to granting interim dividends and issuing new shares (which requires special resolution of the general meeting). Similarly to the other two jurisdictions, also in China has attempted to regulate golden parachutes. The new Article 61 added to the amended Governance Code provides that the articles' provisions and relevant contracts governing early dismissal of directors should be constructed according to the principles of fairness and shall not damage the rights and interests of the company.

The position of other pre-bid defences in China should be similar to that of the UK due to the comparable corporate regime with the shareholders at its centre and similar corporate governance arrangements, yet this is not necessarily the case. Shark repellents, similarly, to the US, are widely used with the majority of firms including them in their articles. This may be explained by the fact that many of such defences do not affect the interests of a controlling shareholder – if the controller wishes a particular deal to go through, it is unlikely that any of those anti-takeover devices would frustrate it. The controller can easily call for a general meeting and instruct the board to remove the measure. The board's power to obstruct the exercise of such right is very limited. Admittedly, certain measures would require an amendment of the firm's articles to be removed, in which case the approval of two-thirds of the shareholders would be needed, what makes it quite difficult even for the controlling shareholders to pursue given that they typically hold approximately 37% of shares in a given company.[1206] However, since the level of voters' turnout at the shareholders meeting is typically very low,[1207] the controller would probably still secure the required special majority. Thus, even with the widespread adoption of pre-bid defences, the interests of the controlling shareholders and, indirectly, the state, which is usually the controller, are well preserved in China.

Regulatory policies towards the issuance of non-voting/ multiple-votes shares allowing directors or shareholders to consolidate control of the firm while holding only a minority stake are different in all three jurisdictions. The US adopts a permissive approach complemented by substantial disclosure

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[1205] See page 119.
[1206] Aminaday and Papaioannou (n1122).
[1207] Institutional Shareholder Services, 'China: Investor Stewardship. An Examination of Voting and Engagement Activities in China' (03 November 2014) <https://www.issgovernance.com/file/publications/china-investor-stewardship.pdf>accessed 10 June 2018.

requirements.[1208] DGCL provides the 'one-share, one-vote' principle as a default rule,[1209] but Delaware firms can opt out of the provision and issue both non-voting shares and shares with multiple voting rights attached. Rules of both the NYSE and NASDAQ permit firms with pre-existing weighted voting rights (WVR) structures to be listed. The bourses, however, do not allow an issuer, once listed, to implement measures reducing or restricting the voting rights of existing shareholders.[1210] Despite the legality of WVR arrangements, the Investor Responsibility Research Centre's study found that only 43 firms included in the S&P 1500 (equal to 3%) have multiple voting shares in issue.[1211] Although the issue of shares with extra voting rights is not prohibited by the Act, the Listing Rules require ordinary shares in a class to carry an equal number of votes on any shareholder vote[1212] and (where a company has more than one class of shares) the aggregate voting rights of the shares in each class should be proportionate to the relative interests of those classes in the company's equity,[1213] which prevents the creation of artificial voting structures designed to allow control to rest with a small group of shareholders.[1214] Notwithstanding the rules on WVR, companies are nevertheless hesitant to introduce such measures due to the strong resistance from institutional investors.[1215] With the 'one-share one-vote' principle, China's approach towards WVR used to be strictly prohibitive. Although since 2014 listed firms can lawfully issue preference shares with no voting rights attached, holders of all shares in certain circumstances, e.g. in the takeover context when shareholders are voting on the deal or when the company proposed to amend its articles, are entitled to exercise one vote per share.[1216] Therefore, creating artificial voting structures through issuance of preference shares cannot serve as a powerful defensive tactic in China.

While China's capital markets are still dominated by SOEs, the share of entirely privately owned companies, with typically more dispersed ownership, has been

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[1208] Hong Kong Stock Exchange, 'Weighted Voting Rights.' (Concept Paper, August 2014) <https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2011-to-2015/August-2014-Weighted-Voting-Rights/Consultation-paper/cp2014082.pdf> accessed 17 March 2018.
[1209] DGCL, 212(a).
[1210] 'Weighted Voting Rights' (n1197).
[1211] IRRC Institute and Institutional Shareholder Services, 'Controlled Companies in the Standard & Poor's 1500: A Ten-Year Performance and Risk Review' (October 2012).
[1212] LR, Listing Principe 3.
[1213] LR, Listing Principle 4.
[1214] FCA, Consultation Paper CP13/15, 2.25.
[1215] Seretakis, 'Hostile Takeovers and Defensive Mechanisms in the United Kingdom and the United States : A Case against the United States Regime' (2013) 8 The Ohio State Entrepreneurial Business Law Journal 247 257-8 ; Gullifer and Payne (n438) 702.
[1216] See page 136.

constantly growing in the recent years.[1217] Whilst such companies have significant capital requirements, their founders are often not willing to give up control to the investors and then become vulnerable in case of hostile takeover attempt. In their empirical research, Brawn and Fawcett found that the main reason for the reluctance of the founders to go public is the desire to maintain control over decision making.[1218] The US caters for such needs by allowing the founders to obtain listing while keeping significant control through the WVR arrangements. Start-ups can be listed with a dual-class share structure, which is the result of the bargaining process through private ordering.[1219] Since China's existing regime does not provide such a solution to this dilemma, firms often seek to launch their IPOs in jurisdictions with more flexible regimes. In 2014 there were 102 large Chinese firms listed on the US exchanges, approximately one-third of which adopted various WVR schemes.[1220] Such arrangements are becoming increasingly popular among the Chinese companies,[1221] particularly in growing, tech-based industries. While listing outside of China allows the existing owners to retain some control of the company, it also makes it easier to attract foreign capital since such companies manage to circumvent the limitations imposed by China's restrictive foreign investment laws.[1222] As a result, Chinese exchanges loose potential listings of valuable firms that often choose to adopt the variable interest entity (VIE) structure[1223] and get listed in jurisdictions that allow WVR, dual share structures and discriminatory AAs.[1224] Well known and profitable Chinese companies such as Alibaba, Lenovo Group, JD.COM, Baidu and Sina Corporation are all listed in the US.[1225] Many of them have their corporate governance designed to maintain significant involvement and the tight control of the founders over the business operations and to protect founder's position in case of an emergence of activist investor or hostile acquisition attempt.

[1217] Lin, 'Non-Legal Protection...' (n7).

[1218] Brau and Fawcett, 'Initial Public Offerings: An Analysis of Theory and Practice' (2006) 61 The Journal of Finance 399.

[1219] The process demands the rational and informed investors to analyse the value of having insider control and the costs of shareholder participation in corporate decision making. Sharfman, 'A Private Ordering Defense of a Company's Right to Use Dual Class Share Structures in Ipos' (2008) 63 Villanova Law Review 1.

[1220] MSCI, 'Corporate Governance in China' (September 2017) <https://www.msci.com/documents/10199/1d443a3d-0437-4af7-aa27-ada3a2655f6d> accessed 10 February 2018.

[1221] 'Weighted Voting Rights' (n1197).

[1222] State Council maintains a long list of sensitive industries in which foreign investors are forbidden from becoming shareholders.

[1223] VIE is a structure created to avoid foreign investment restriction laws in China. As of now, the Chinese regulations has not confirmed the legal validity of the VIE structure. While no action against any of the firms that adopted VIE structure has been taken to date, investors are exposed to a risk of the design being struck down by the authorities. 'Corporate Governance in China' (n1209.

[1224] ibid

[1225] ibid

6.3. Directors Role in the Takeover Context

Directors in all three jurisdictions are subject to fiduciary obligations. China, despite its civil law tradition, imposes corporate fiduciary duties on the firm's directors, supervisors and senior managers. Directors have a statutory duty of care and duty of loyalty under the Company Law which, constitutes a transplant from the Anglo-American tradition. While Article 148 of the Company Law does shed some light on the duty of loyalty, the duty of care is not further specified in the law. The concept of fiduciary obligations which, in the US and the UK is established through common law (and equitable principles in the UK), is underdeveloped in China's regime.

One of the main areas of concern involving directors' duties in China is linked to identity of the main beneficiary of these duties in a takeover context as although Company Law provides that directors owe their duties to the company, Article 8 of the Takeover Measures states that the duties of directors are towards both the company and its shareholders. Explicit provision for the benefit of these two constituencies may indicate that their interests are separated from each other and both of them should be protected in the takeover context. If one assumes that the interests of the company and its shareholders are indeed not identical, they may diverge in the face of a particular hostile acquisition. This creates uncertainty as to whom fiduciary obligations are owed in case of a conflict of interests and whose interests should be given precedence when the board is faced with a hostile takeover attempt.

Although in the US the fiduciary duties are owed to the company and its shareholders and in the UK directors owe their duties to the company, there is no material distinction in substance since shareholders as a whole personify the company in the UK.[1226] Whilst the DGCL in Delaware and the CA 2006 in the UK do not specify the precise nature of fiduciary duties, the concept is well-established and recognised through decisions of the courts. In China the cases involving alleged breach of fiduciary duties by directors of listed companies decided by court are very limited in number, and the cases involving duties of listed company's directors in the takeover context are basically non-existent.[1227] Thus, at the moment, private litigation over directors' duties in China cannot be considered an essential force in providing guidelines to developing the concept of directors' duties in China. It may therefore be helpful to understand how the

[1226] See page 66.
[1227] The CSRC, however, applied the concept of fiduciary duties (mainly duty of care) in some of its decisions; see page 115.

issue of potential conflict of interest has been resolved through case law in the US and the UK.

It seems to be recognised by the takeover regimes of both the US and the UK that the interests of the company and those of its shareholders may diverge in the context of hostile takeovers. Under the *Unocal* standard the board may balance the takeover premium available for shareholders against the potential effects of the acquisition on the firm. When deciding whether to defend the firm against a hostile suitor, the board is explicitly permitted to consider the impact of the bid on constituencies other than shareholders.[1228] The wording of *Unocal* is not clear as to how the directors should balance the mentioned interests, e.g. whether a non-coercive offer above the market price can be rejected on the grounds that the bidder plans to close the plants and lay off numerous employees. Directors' approach to the stakeholders' interests, however, must differ based on whether the company is in *Unocal* or *Revlon* mode. Once the firm enters into the land of *Revlon*, that is when the break-up of the company is inevitable,[1229] the board should only focus on obtaining the best attainable price for the shareholders. Under such circumstances, directors are not allowed to consider the interests of other constituencies, all they have to be concerned with is how to maximise the value they can obtain from the acquirer for the sole benefit of the target shareholders. One should note that even in *Unocal* mode the interests of stakeholders cannot be treated as an end in itself. As explained by the Supreme Court in *Revlon*, directors may consider various constituencies when discharging their responsibilities, provided that there are rationally related benefits accruing to the shareholders.[1230] It means that the impact of a successful takeover on stakeholders may be taken into consideration by the board only if doing so benefits equity holders. Bainbridge hence argues that the protection of the interests of other constituencies at the expense of shareholders' welfare is prohibited under Delaware law.[1231]

In the UK, it was recognised by Lord Cullen in *Dawson International plc v Coats Paton plc,*[1232] which then was cited by the Court of Appeal in *Arbuthnott v Bonnyman*[1233] that directors' duties in a takeover context are owed to the company, not the current individual shareholders with respect of selling their shares. Whilst directors should consider the interest of shareholders when

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[1228] *Unocal* (n245) 955.
[1229] See page 37.
[1230] *Revlon* (n244) 176.
[1231] Bainbridge, *Corporate Law* (n246) 447.
[1232]*Dawson International* (n495) 314.
[1233] [2015] EWCA Civ 536, 50.

discharging their duties to the company, the interest of current shareholders may not necessarily coincide with that of the company. [1234] The principle was reaffirmed in *Sharp v Blank*.[1235] Although directors in the UK are removed from decision-making in the context of hostile acquisitions involving listed firms, doubts of a similar nature as those just discussed in the US did existed in relation to their obligation to provide the opinion to the shareholders, especially whether directors' recommendation of the offer can be based on considerations other than the price, given their duty under Section 172 of CA 2006 to have regard to stakeholders other than the company's shareholders. Both the case law and the Takeover Code are clear that the board is under no obligation to recommend the offer with a substantial premium over the market price because when providing their opinion directors are not required to consider the bid price as the determining factor nor they are prohibited from considering other factors which they found relevant. Where there is a conflict between the interests of the target company as a whole and those of its current shareholders because, for example, the board considers the offer price to be adequate (hence beneficial to the current shareholders) but it does not believe that the acquirer would promote the success of the company following an acquisition, the interest of the company prevails. [1236] While directors' recommendation can be based upon the consideration of, among others, long-term interest of the company and its employees, it is left entirely up to the shareholders to decide whether or not to take these interests into consideration. Pursuant to the statement made in *Re Astec:*[1237] 'the starting point is the proposition that in general the right of a shareholder to vote his shares is a right of property which the shareholder is free to exercise in what he regards as his own best interests.' [1238] In such case, permitting the directors to 'see the big picture' when analysing and recommending the takeover offer seems reasonable as it allows the shareholders to get informed about the effect of the successful bid on the company and its stakeholders which, most likely, the shareholders would not be troubled to do on their own. At the same time, however, because of the board neutrality rule, there is no risk of directors in the UK using the right to consider other constituencies to frustrate the offer for their own benefit.

Since it is the shareholders who are the main decision-makers and directors have no power to frustrate the bid based on the consideration of the company's long—

[1234] *Dawson International* (n495) 314.
[1235] See fn 496.
[1236] See page 65.
[1237] *(BSR) plc* [1998] 2 BCLC 556.
[1238] ibid 584-585.

term interest, the UK's takeover regime has often been criticised as favouring short-term shareholders at the expense of other shareholders and non-shareholder stakeholders.[1239] The Panel, however, decided to approach this problem by requiring an extensive disclosure regarding the long-term commercial justifications for the offer and acquirer's intentions as to the future business of the target firm, its employees and likely repercussions on the locations of places of business. Acquirer's compliance with commitments made in regard to post-acquisition is monitored and enforced through requirement to submit periodic written reports to the Panel and possibility to appoint an independent supervisor to oversee the process.[1240] Although these arrangements do not fundamentally alter the power dynamics of takeover decision-making, as it is still for the informed shareholders to decide whether to accept the offer, it does afford some protection to the company and its constituencies without sacrificing board's accountability in the takeover context.

6.4. Selected Corporate Governance Mechanisms

In terms of control rights the shareholders are the most powerful organ in the corporate structure of the UK and China's firms, whereas in the US it is the board of directors that constitutes the central organ of the firm with the shareholders having significantly less power conferred on them.[1241] The issue of amendment of the company's constitutional documents and whether or not the board must be part of the process or has a right to autonomously amend them is very important also in a takeover context. Giving the board such power lessens the control rights of the shareholders and equips the board with a very broad discretion, as it can quickly introduce anti-takeover measures if such need arises. The general meetings in the UK and China are both given the authority to make decisions on a broad range of issues, not necessarily limited to the 'end of the game' and changing the 'rules of the game' transactions as it generally is in the US. What is more, at least ostensibly, the power of shareholders in China is even more wide-ranging than in the UK, as shareholders not only have a statutory right to formulate and approve company's business strategies but also to instruct the board by the way of ordinary majority. When it comes to amending the company's articles, the shareholders in both the UK and China are equipped with proposal right, the right to call for the general meeting and the right to approve the amendments to the articles. In the UK the board is not required to participate in the process, nor it has authority to amend the articles by itself. In China the

[1239] See page 69.
[1240] See page 81.
[1241] See Parts 2.3, 3.3 and 5.4.

law remains silent as regards board participation in the amendment process. It is the shareholders who are entitled to pass a resolution amending the firm's constitutional document, but it is not established who is responsible for formulating the proposed changes. Therefore, a provision giving the board exclusive power to propose and formulate amendments can be included in the company's articles, which may limit the shareholders' authority and provide the board with opportunity to adopt takeover defences, especially in the form of some entrenching provisions.

The laws of both the UK and China do not restrain shareholders' rights to remove and replace the company's directors. Whilst in the UK it is strictly prohibited to alter Article 168 of CA 2006 in the company's articles to prohibit removal without cause, in China it is still somewhat an unresolved issue whether the company can protect directors by prohibiting removal without cause.[1242] Moreover, while in both jurisdictions directors' nomination and election process is provided in the countries' corporate governance codes, China's Governance Code contains provisions which regulate procedural aspects of elections very broadly leaving a broad discretion to individual firms to formulate rules governing the process. As a result, the process is commonly controlled by the incumbent board which often results in formation of obstacles to the effective exercise of shareholders right to elect and remove directors.[1243] In the UK's companies subject to the CG Code the elections should be held annually, which allows a reasonably smooth change of the board's membership following change of control transaction. US companies, on the other hand, typically hold directors' elections annually but the shareholders of the firms that adopted staggered boards can only replace one-third of the board each year. Such firms may furthermore include in their charter the provision prohibiting director's removal without cause, which makes the process of obtaining control rather expensive and time consuming even after a successful takeover.[1244] Both in the UK and China it is relatively easy for shareholders, especially in comparison with the US, to call for a special meeting or add proposals to the agenda of the general such as director's removal and elections, therefore the impediments the board is able to create for qualified shareholders to exercise their will to replace directors is rather limited.

The similarities between the UK and China's corporate regimes are not surprising given the fact that China's Company Law has been largely

[1242] See pages 109 - 110.
[1243] See pages 118 - 119.
[1244] See page 40.

transplanted from Hong Kong, which, as already mentioned,[1245] itself has its laws modelled on those of the UK. In terms of the identity of the main decision maker, both jurisdictions can be characterised as 'shareholder-centric', while the US's regime can be described as the 'board-centric' model of corporate governance (also within the area of takeover regulations). However, when it comes to the main beneficiaries of the firm's decision-making, the UK and the US can be both considered an example of the 'shareholder-oriented' model, in a sense that the firms in practice are managed in the best interest of their shareholders, while the situation in China is not such straightforward. One would naturally assume that the main beneficiary of shareholder-centric model would be the shareholders as a whole. When discussing global convergence of corporate governance practices, Hansmann and Kraakman[1246] provided China as an example for the general trend of the convergence towards the shareholder-oriented model. Indeed, China's system of corporate governance on the books has almost all characteristics attributable to that model. However, placing law in books in the socio-political context helps to uncover the ultimate main beneficiary of the system i.e. the state, and as such, China's supposedly functional adoption of shareholder-centric model becomes less evident. Such system applied in the UK, where the vast majority of firms have dispersed yet well-informed and sophisticated institutional investors, is more likely to operate efficiently and effectively for the benefit of all shareholders. To pass a resolution or replace the directors the insurgent shareholder initiating the corporate action would need to solicit and obtain support from other shareholders because its stake alone would most likely be insufficient to carry the resolution. In light of this, it is doubtful that a resolution harming the interests of minority shareholders would be passed at the general meeting. Extracting any significant benefits by an individual shareholder at a cost of minority shareholders is also of limited feasibility in such system. Contrariwise, the provisions giving shareholders broad authority adopted in a jurisdiction with a highly concentrated ownership structure does not necessarily work for the benefit of shareholders as a whole. In China, the state as a powerful controlling shareholder can often pursue its own interests at the expense of other shareholders and the firm as a whole through the institution of the general meeting. Coupled with a low rate of private enforcement in listed companies, the controller's ability to engage in self-

[1245] See page 91.
[1246] Hansmann and Kraakman, 'The End of History for Corporate Law' (2000) Harvard Law School John M Olin Center for Law, Economics and Business Discussion Paper Series 280; Hansmann and Kraakman, 'Reflections on the End of History for Corporate Law' (2011) Yale Law & Economics Research Paper No. 449.

interested strategies is hardly restricted. The state as a controlling shareholder itself is however well protected against both internal (from the firms' directors) and external (e.g. from the market for corporate control in the form of coercive bids) abuse. Such system offers directors a limited ability to entrench themselves: even with the absence of a board neutrality rule, the controlling shareholder dissatisfied with the board's conduct can easily call for an special meeting to either instruct the board to stop frustrating the bid or to remove the incumbent directors and replace them. In China the whole process should, in theory, take a maximum of two months.[1247] Thus, the empowerment of the shareholders meeting, gradual liberalisation of the takeover regime and even the recent ultimate removal of the pre-approval system do not significantly alter the position of the state both in general and in the takeover context. It, therefore, may appear that the orientation of corporate governance arrangements adopted by the analysed jurisdictions is where the UK and the US diverge to a certain extent and the UK and China converge, but such convergence is, at least for the time being, ostensible.

Despite similar corporate governance arrangements making shareholders the organ of power, the risk of abuse of the minority shareholders is not a cause for concern in the UK not only due to the widely dispersed ownership structure, but also because of relatively effective protection afforded to the minority shareholders.[1248] China, similarly, to the UK and the US, provides for some *ex-ante* protection measures embedded in corporate governance and *ex-post* remedies available to shareholders via direct actions and derivatives suits. In theory, minority shareholders in China, similarly to their counterparts in the UK, can also use the general meeting to effect measures aimed at stopping the undesirable behaviour. However, the ownership threshold of 3% required to propose resolutions to be decided at general meeting, or the even more demanding threshold of 10% (5% in the UK) needed to call for a special meeting, may constitute a barrier for effective use of those rights given the characteristics and ownership patterns of minority shareholders in China. Since the second largest shareholder typically holds approximately 7-9% of a listed firms' shares,[1249] if a minority shareholder considers that its position is being

[1247] Special meeting must be held within two months after the shareholder's request, even if the board refuses to convey such a meeting the shareholders are entitled to do it themselves. See CL, art 100.
[1248] See derivative claims under ss260-264 of CA 2006 (in England and Wales or Northern Ireland), derivative proceedings under ss265-269 of CA 2006 (in Scotland) and unfair prejudice petition under s994 CA 2006 for *ex-post* remedies.
[1249] Chen and Du 'Does Regulatory Reform of Cumulative Voting Improve Minority Shareholder Protection?' Working Paper (10 July 2017) <http://kjxy.dufe.edu.cn/uploadfile/2017/0710/20170710035528392.pdf> accessed 16 May 2018.

prejudiced, it would be difficult to call for the general meeting, unless the investors with a small stake were able to work together. This is, however, improbable as a collective action problem is a common issue among the shareholders of Chinese companies (with the exclusion of the controlling one).[1250] Even if minority shareholders somehow managed to mobilise and call a meeting, they are unlikely to pass any resolution the controlling shareholder is against because the voters' turnout in China is on average as low as approximately 55%,[1251] compared to approximately 86 % and 71 % in the US and the UK respectively,[1252] which typically allows the controller present at the meeting to veto any minority-proposed resolution with ease.

Despite the arrangements aimed at empowerment of shareholders and facilitation of their engagement, the role of a shareholders' meeting as an effective *ex-ante* protective mechanism is therefore often diluted. A variety of causes explains the existing situation with the main one being an infancy and immaturity of China's capital markets. Underdevelopment of institutional investors and high ownership percentage of the retail ones[1253] who tend not to make an effort to vote at the general meetings (hence low voters' turnout) further account for the existing situation in China. Moreover, Chinese domestic investors are generally not as engaged in corporate governance as their foreign counterparts, therefore the fact that foreign ownership in China's listed companies accounts for less than 5% provides an additional explanation of shareholders' lack of interest in governance of the company.[1254] Late distribution of often insufficient materials and lack of transparency in the voting process additionally hinder shareholders' participation in decision making.[1255] It is rather unlikely that in a takeover context these shareholders would act differently, even if their interests were compromised.

The characteristics of the board of directors may play a role in a takeover context as e.g. the institution of independent directors and independence of the board as a whole are both believed to influence the extent of type I and type II agency conflicts.[1256] Pursuant to the CG Code, at least half of the board in UK listed

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[1250] See page 155.
[1251] 'China: Investor Stewardship' (n840).
[1252] ibid
[1253] See page 155.
[1254] 'China: Investor Stewardship' (n840).
[1255] ibid
[1256] However, various empirical research conducted in the US and the UK provided mixed evidence as to whether the presence of independent directors reduces agency costs. For summary of the output of empirical studies conducted in the US see NYSE, 'Corporate Governance Guide' (December 2014) 8-10 <https://www.nyse.com/publicdocs/nyse/listing/NYSE_Corporate_Governance_Guide.pdf> accessed 12 June 2016.

firms must consist of independent NEDs. Although Delaware law does not explicitly regulate the requirement of independent directors on the board,[1257] the rules of the nation's stock exchanges demand the majority of the board of listed firms to be independent.[1258] Moreover, certain board committees, e.g. the committee created to deal with conflicted transactions such as takeovers, must contain exclusively independent directors.[1259] In China, the Independent Directors Guidelines require that at least one-third of the board of listed company should be independent.[1260] Having an adequate number of sufficiently independent directors on the board appears to be of crucial importance in China given the prevailing shareholder structure and the ability of the dominant shareholder to control the board and the shareholder meetings, as well as the limited effectiveness of other provisions protecting minority shareholders. Although under such circumstances, a completely unbiased governance of the firm may not be achievable, presence of independent directors makes the genuine protection of the interest of all the shareholders including the minority, possible and attainable, also in a takeover context. Their opinion on a hostile takeover bid may prove to be particularly valuable not only because they are likely to consider the interest of all company's shareholders, but also because they are more likely to be less personally interested in the outcome of the bid than the executives due to e.g. smaller personal financial consequences in case of a successful acquisition. Those alleged benefits, at least for the time being, may not materialise in China since research conducted by Huyghebaert and Wang,[1261] indicated that independent directors in China are typically not sufficiently autonomous vis-à-vis the controlling shareholder. Despite the fact that many of the independent directors are highly qualified experts they seem unable to protect the firms' minority shareholders against the expropriation on the part of dominant shareholder. One of the reasons behind the situation is that in practice independent directors are very often appointed by the firm's controlling shareholders, what results in the Chinese firms' boards being

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For summary of the output of empirical studies conducted in the UK see Liu and Anderson, 'Mind the Gap: Expectations on the Role of UK Non-Executive Directors', Regent's Working Papers in Business & Management Working Paper No 1402 (February 2014) <https://www.regents.ac.uk/media/975652/RWPBM1402-Liu-J-Andersson-T.pdf> accessed 13 December 2017.

[1257] Although it encourages the company to have independent directors by eg providing that the burden under the entire fairness standard of review will be shifted to the plaintiff challenging a transaction if such a transaction was approved by an independent special board committee. See *Re MFW Shareholders Litig*ation, 67 A.3d 49.

[1258] See page 33.

[1259] NYSE Manual, ss 303A.04 – 303A.07 and NASDAQ Rules, 5605(c)-(e).

[1260] See page 111.

[1261] Huyghebaert and Wang, 'Value Creation and Value Distribution in Chinese Listed Firms: The Role of Ownership Structure, Board Characteristics, and Control' [2017] The European Journal of Finance 1 5

dominated by insiders.[1262] Not surprisingly, since a genuine independence of independent directors in the Chinese companies constitutes a rarity, the boards often merely rubber-stamp the decisions made by the executive directors and the firm's dominant shareholder,[1263] although there were cases where the CSRC imposed an administrative penalty on directors who supported decisions of insiders without having engaged independent decision-making.[1264]

In terms of the independence of the board as a whole assessed by how easily it can be influenced or pressured by the shareholders and the controllers in particular, the US leads among all three jurisdictions. Main decision-making power vested in the board, limited control rights of the shareholders especially manifested by the board's participation in the process of amendments of corporate arrangements,[1265] cause that type II agency problem is not particularly prevalent in the US. It should be noted however, that the shareholder activism did put the US boards under a lot of pressure in recent years.[1266] Nevertheless, because of the various anti-takeover measures aimed to protect the office of the directors, unless shareholders are extremely dissatisfied and willing to invest a lot of resources in terms of time and finances to launch a proxy fight (and even so, they would often be able to replace only a fraction of the board), directors can fulfil their duties without much of interference from the individual shareholders, even the dominant one. Of course, such situation presents a risk of increased occurrence of type I agency problem, thus it is of great importance for the regulators to indicate the main sources of risk and abuse in any given jurisdiction and adopt such provisions of company law and corporate governance that would strike a balance between the need to ensure that the board can fulfil its duties without too much interference and pressure from the shareholders and accountability in a sense that if directors abuse their powers or engage in self-interest activities they will face the consequences of such conduct.

Another corporate governance arrangement which is believed to reduce agency costs is the separation of the CEO and the chairman positions.[1267] Listed firms in the UK are required by the CG Code to have a separate board leadership structure and the vast majority of them comply with the provision.[1268] It was a

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[1262] ibid 5.
[1263] ibid 25.
[1264] For examples of such cases see Zhou, 'Is the CSRC Protecting A'level Playing Field'in China's Capital Markets: Public Enforcement, Fragmented Authoritarianism and Corporatism' (2015) 15 Journal of Corporate Law Studies 377, 394-6.
[1265] See page 29.
[1266] See eg pages 41 and 44.
[1267] Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems' (1993) 48 the Journal of Finance 831.
[1268] See page 64.

very common practice in the US to combine these positions, however due to the efforts of active investors within firms there is clearly an increasing trend to separate them.[1269] In China the trend appears to be the opposite - while Firth, Lueng and Rui in 2006 reported that the two positions are usually separated (only 11% of firms in the sample combined them)[1270], according to research conducted by Yu and Ashton the percentage of companies pursuing CEO-chairman duality has been gradually increasing over the years to reach 22.5% in 2010.[1271] Such a trend is worrying, especially when considering the weak position of independent directors in China.

As explained earlier[1272] the risk of the opportunism of executives vis-à-vis shareholders, although smaller, nevertheless exists in China. One may argue that the role of the market for corporate control as a disciplining device is not particularly relevant in China because of the concentrated ownership and the corporate governance model designed to discipline the conduct of the board. China adopted two levels of monitoring: firstly, the executive directors should be supervised by the independent directors within the board's structure and secondly, each listed firm is required to have a supervisory board responsible for monitoring the board of directors. While in theory having a two-tier governance structure should enhance monitoring effectiveness, in China this is typically not the case in practice.[1273]

The incentives and ability of internal monitoring bodies are generally not free of external disciplining devices consisting of i.e. the state's legal and institutional infrastructure, managerial market, shareholder activism and the market for corporate control.[1274] While the managerial labour market is one of the important monitoring forces in the UK and the US, the market in China is still at the developing stage. It is also compromised by the omnipresence of political connections.[1275] Another obstacle to the proper functioning of the model of internal monitoring is a shortage of independent directors and supervisors with suitable expertise.[1276] Despite these weaknesses, empirical studies by Stella Cho

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[1269] See page 32.
[1270] Firth, Leung and Rui (n1162) 395.
[1271] Yu and Ashton, 'Board Leadership Structure for Chinese Public Listed Companies' (2015) 34 China Economic Review 236.
[1272] See pages 156-157.
[1273] See page 110.
[1274] Cho and Rui, 'Exploring the Effects of China's Two-Tier Board System and Ownership Structure on Firm Performance and Earnings Informativeness' (2009) 16 Asia-Pacific Journal of Accounting and Economics 95.
[1275] Lin, 'Non-Legal Protection...' (n7) 57; Kang, 'The Independent Director System in China: Weaknesses, Dilemmas, and Potential Silver Linings' (2016) 9 Tsinghua China Law Review 151 184.
[1276] Kang (n1275).

and Oliver Rui[1277] and Wei Gu[1278] reported that, although modestly, both independent directors and the board of supervisors of Chinese companies have adequate incentives to discipline executive directors. Furthermore, executive directors themselves are becoming more receptive to the influences of capital markets.[1279]

Shareholders as a group, who constitute another important monitoring mechanism in the UK and the US, in China are often believed to lack incentives for effective supervision of the firm's executives despite, or perhaps because of, the concentrated ownership structure of Chinese firms. Nomination and appointment of the board members are usually controlled by the controlling shareholder,[1280] resulting in the insiders' dominated board which may discourage other shareholders from investing their resources to monitor the board. Indeed, empirical evidence of Wei Gu indicates that the representatives of the major shareholders in SOEs are rarely disciplined even if their performance is less than optimal. The executive directors in the privately-owned companies, on the other hand, tend to be monitored by the shareholders and are held accountable more effectively.[1281]

6.5. General Provisions Regulating Takeover Bids

China's takeover regime adopted such mechanisms as the requirement of information rights, withdrawal rights and sell-out rights which aim to protect all shareholders by providing them with fair treatment. The space for coercive offers is therefore limited, which at least in theory allows all shareholders, not just controlling ones, to enjoy undistorted choice.[1282] A strong protection for the minority shareholders and, at the same time, the manifestation of the equality principle is the MBR provided by the UK and China where investors that purchase 30% of the company's shares (in the UK: voting rights) must extend their offer to the rest of the shareholders. A general offer addressed to all[1283] shareholders allows them to exit the company following change in control[1284] while having a right to share in the premium paid by the bidder. The force of the MBR does not come only from the obligation to make a full offer, but also from

[1277] Cho and Rui (n1274).
[1278] Gu, 'Corporate Governance of Chinese Publicly Listed Companies' (DPhil thesis, University of Nottingham 2013).
[1279] Cho and Rui (n1274).
[1280] See Part 5.4.1.
[1281] Gu (n1278).
[1282] For a discussion on undistorted choice see Bebchuk, 'Toward Undistorted Choice and Equal Treatment in Corporate Takeovers' [1985] Harvard Law Review 1693.
[1283] Partial offers are also permitted under China's takeover regime.
[1284] It is recognised that due to dispersed corporate ownership having less than 50% of the company's voting rights may provide control of the company.

supplementary requirements regulating the terms of the offer. In both jurisdictions the best price rule dictates that the consideration paid to the tendering shareholders must not be lower than the highest price paid for shares of the relevant class within the offer period and the 6 months (in China) or 12 months (in the UK) preceding it. The MBR ensures that all shareholders can equally benefit from a transaction by having a chance to obtain the same price for their shares. Secondly, it prevents a situation when an acquirer obtains a controlling stake at a premium price from a controlling shareholder or a few large shareholders and then buys out the remaining shareholders at a discounted price due to their minority status. Thirdly, the MBR protects the company against coercive offers designed to threaten and pressure shareholders to tender their shares as it is addressed to all the shareholders, so they are not indirectly forced to sell their shares even if they are not satisfied with the merits of the bid. Apart from direct protection of the firm's existing investors, the MBR also discourages bidders who seek to extract private benefits of control rather than enhancing the value of the company for the benefit of the company and its shareholders.[1285] Under the circumstances where all shareholders, including minority shareholders, are effectively protected against abuses, an argument for granting the board of directors an active role in the protection of shareholders in the context of hostile takeovers is not justified, as it is the case in the UK. One should note that the Delaware regime does not provide for the MBR, because such protection offered to the shareholders comes at a very high price for the bidder, which is believed to cool down the vitality and contestability of the market for corporate control. Since the mandatory offer has to be made to all the shareholders at an equitable price, the financial resources needed to close such a transaction are significantly higher than in a regime that does not have an MBR requirement.[1286] Consequently, bidders who may be willing to conduct a takeover to enhance company's value as a whole may not be able to do so because of lack of sufficient resources to launch a full tender offer. Under both the UK and China's jurisdiction the takeover supervisory authorities are permitted to exempt certain transactions from the regime, e.g. when the target is a distressed company. The majority of MBR waivers in China were officially granted on the ground of increasing efficiency by allowing value-enhancing takeovers.[1287] It appeared that Chinese regulators agreed that some takeovers may constitute the most effective rescue for companies experiencing financial

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[1285] Davies and others (n493).
[1286] Kraakman and others, 'The Anatomy of Corporate Law: A Comparative and Functional Approach' (2009) Oxford University Press 268.
[1287] See page 137.

difficulties whereas requirement to launch a full offer may deprive such companies from being rescued. In practice, however, such exemptions were often granted mainly to protect the interests of the state by saving poorly performing SOEs from bankruptcy through the facilitation of their acquisitions by better performing firms.[1288] The waiver from the mandatory bid, therefore, used to be easily obtainable and granted excessively by the CSRC, which made the MBR and all the supplementary provisions effectively useless in protecting the rights of minority shareholders. Despite the reform of MBR (since 2006 the acquirer in China is permitted to launch a partial offer even under the MBR regime), the CSRC still enjoys a very broad discretion in granting exemptions. The absence of the effective MBR and no requirement to launch a full offer may work well in the US where the corporate ownership is dispersed, other forms of minority shareholder protection are embedded in the regime[1289] and the board of directors plays a full-scale role in protecting the firm against coercive offers. However, in China such indiscriminate discretion given to the CSRC and the potential to launch a partial bid effectively strips minority shareholders of the protection against certain abuses, while not providing alternative protective mechanisms.

The *ex-post* remedies in theory available to minority shareholders of Chinese firms are also of limited importance for their overall protection in the takeover context since private enforcement mechanisms for the rights of shareholders in listed firms is rather rare in China. Both directors and controlling shareholders are subject to fiduciary duties, but since the controllers are often the state or state-connected entities, the enforcement of such duties is not particularly effective, especially in light of the court's independence problems, unfavourable rules on litigation fees and an extremely rare use of derivative actions by shareholders of public firms.[1290] Minority shareholders, therefore, usually rely on public enforcement to safeguard their rights and interests during the takeover bid. The empirical research conducted by Tianshu Zhou, however, indicated that the CSRC often offers preferential treatment to the central SOEs, enforcing regulations with less rigour than in case of local SOEs and privately-owned firms,[1291] which undermines the protection of minority shareholders in those firms. The absence of self-enforcing provisions such as requirement to launch a

[1288] Xi, *Corporate Governance…* (n1018) 98-9.
[1289] Gillen, 'Economic Efficiency and Takeover Bid Regulation' (1986) 24 Osgoode Hall Law Journal 919.
[1290] See Part 5.7.2.
[1291] Zhou (n1264).

full offer instead of a partial one when the acquirer wants to purchase a control of company is therefore rather undesirable in China.

6.6. The Role of Financial Advisors

The boards of the UK- and China- incorporated target firms are required to obtain independent financial advice regarding the offer. Whilst the US target board is under no such requirement, the boards tend to obtain the so-called 'fairness opinion' from a qualified financial advisor regarding the adequacy of the offer. It often serves as evidence that the directors exercised diligence in making an informed decision before advising on a takeover transaction, which can be useful in court, especially given the very high litigation rate of M&A transactions in the US.[1292] The fairness opinion is prepared for the directors with the purpose of assisting them with providing the recommendation to the target shareholders and, as such, it does not have to be supplied directly to shareholders. In China, on the other hand, the opinion must be disclosed directly to the shareholders, while in the UK only the substance of the opinion given to the board must be included in a target board's circular sent to the company's shareholders.

The requirement as regards the independence of the advisor varies depending on the jurisdiction. While in the UK and China the institution providing consulting services must ensure sufficient independence, in the US there is no such requirement. In fact, it is a relatively common practice that the target firm either uses its in-house lawyers to provide the fairness opinion or employs an external advisor fulfilling a dual role by working on both selling and buying side of the transaction.[1293]

Financial advisors working for firms incorporated in the UK and China are responsible for ensuring that the target directors are aware of and understand their duties in the context of takeover transactions. The role of the advisors under China's takeover regime is further expanded to include extensive monitoring and supervising functions towards the board, what, as noted by Chao Xi effectively makes the advisor a private enforcer of the takeover regime.[1294] The extensive responsibilities of financial advisors in China, and their quasi-enforcement role,

[1292] See page 184.
[1293] See page 54.
[1294] See page 140.

may be partially explained by the attitudes of the CSRC towards the competence and independence of China's judiciary.[1295]

With great responsibility comes only some accountability. The financial advisor in China may be jointly and severally liable together with the acquirer, however it appears that under the Takeover Measures it is the CSRC who is mainly responsible for monitoring financial advisors' conduct. Although shareholders have a private right of action against financial advisor for misrepresentation under Securities Law, there is a number of procedural burdens which may make it difficult for shareholders to seek enforcement in court.[1296] Thus, in practice financial advisors in China are primarily disciplined by the CSRC rather than the courts, which can be rather problematic given their extensive role in takeover transactions and constraints of resources and personnel experienced by the CSRC's enforcement division[1297]. Despite the significantly narrower range of responsibilities of the financial advisor in the US, the target shareholders of firms incorporated in Delaware have a right to sue for aiding and abetting the breach of directors' fiduciary duty.[1298] Although the Chancery Court in *Re Zale Corporation Stockholder Litigation*[1299] initially provided that an aiding and abetting claim may survive even if the claims against the directors themselves are dismissed, in the following opinion the Chancery Court reversed course[1300] providing that there can be no liability for aiding and abetting a fiduciary breach, if there was no breach of directors' duties in the first place.[1301]

6.7. Enforcement of Directors Duties in the Takeover Context

Public enforcement in the UK and China constitutes the main source of enforcement of takeover rules, including those regulating directors' conduct. Unlike the UK's Panel, China's regulator is not an organ independent from the state and the enforcement of takeover regime in China thus features some level of state control. In the US the tender offer procedural rules and the federal proxy rules are enforced primarily by the SEC, while corporate law, including the

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[1295] See page 201 on the CSRC's approach towards China's judiciary.
[1296] See page 145.
[1297] See page 148.
[1298] See page 55.
[1299] No CV 9388-VCP, 2015 WL 5853693 (Del. Ch. Oct. 1, 2015) (*Zale I*).
[1300] No CV 9388-VCP, 2015 WL 6551418 (Del. Ch. Oct. 29, 2015) 13-15 (*Zale II*).
[1301] The financial advisor, however, can be found liable for aiding and abetting directors' fiduciary breach even if the directors face no liability (eg where directors have been dismissed from the case because the claims against them are for exculpable offenses). See Weinstein, Richter and Epstein, 'The Most Important Developments in M&A Law in 2017' HLS Blog (11 January 2018) <https://corpgov.law.harvard.edu/2018/01/11/the-most-important-developments-in-ma-law-in-2017/> accessed 17 June 2018.

board's conduct in the context of takeovers, is enforced predominantly by Delaware state courts.

Although private parties in the UK and China can also seek to protect their rights and interests in the takeover context through litigation, the rate of private enforcement in the UK and China differs significantly from that of the US. Since the first years of the Takeover Code's enactment there were only 43 reported cases of private proceedings involving takeover deals in the UK,[1302] which constitutes only approximately 1% of completed transactions. [1303] Approximately 40% of the claims were brought by the target shareholders and 19% of the cases involved the breach of directors' duties.[1304] The litigation rate in the US is significantly higher, in some years accounting for up to 90% of large public takeovers.[1305] Class actions by the target shareholders alleging a breach of directors' fiduciary duty have traditionally been the most common litigation strategy. [1306] Difference in percentage of deals being litigated may seem astonishing, but one must note that in their study of M&A litigation in the US, Cain and Davidoff Solomon only reported the cases involving very large deals, while the calculated percentage in the UK based on all reported cases regardless of the value of the transaction. It is possible that deals with greater value are more likely to be litigated. It is difficult to assess the exact litigation rate in China, but preliminary research conducted by the author[1307] showed that the number of M&A lawsuits involving listed firms has generally been very low with no cases brought by target shareholders against directors of listed firms in the context of takeovers.[1308] In 2011, Armour, Jacobs and Milhaupt claimed that at the moment of their study which analysed evolution of takeover regime in China it was not clear whether Chinese courts would accept cases involving takeovers,[1309] which suggests that there was no such case brought to date. It may

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[1302] In the years covering the period of 1960 - 2016. See Morley (n1195) 90-92.
[1303] ibid
[1304] ibid
[1305] Takeovers involving value greater than USD100 million between 2010 and 2015. Cain and Davidoff Solomon, *Takeover Litigation in 2014* (Berkley Centre for Law, Business and the Economy 2015).
[1306] Cain and others, 'The Shifting Tides of Merger Litigation' (2018) 71 Vanderbilt Law Review 603.
[1307] The preliminary research was conducted using the database of Peking University: <Chinalawinfo.com> searching against possible causes of action eg Article 147 of CL, Article 151 of CL, Article 8 of TM, Article 33 of TM. Terms such as 'tender offer', 'hostile takeover', 'directors' duty of loyalty', 'directors duty of care', 'breach of duty' were also sought within corporate and securities cases. There were suits involving disclosure obligations in the course of takeover, especially in regard to concerted parties, but these suits concerned only private companies.
[1308] The preliminary study is consistent with prior empirical studies claiming none or extremely limited number of derivative actions brought by listed firms. See eg, Lin, 'Derivative Actions...' (n1086) 635 (out of 77 cases identified since 2005 only one involved a listed company: a *Santian Shangshe* case); Howson and Clarke (n767) 276 (up to 2010 there was only one derivative suit brought by shareholders of listed firms. The identified case has been named in China's official court documents as 'the first shareholders' representative suit regarding a listed company in China's capital markets').
[1309] Armour, Jacobs and Milhaupt (n161) 221.

be, therefore, concluded that whilst private action against target directors plays a very significant role in the US in enforcement of directors' duties regime in a takeover context, its significance in both the UK and China is very modest, or even non-existent.

There may be multiple factors influencing the rate of private enforcement of takeover rules.[1310] Differences in laws, including general rules of civil procedure, substantive legal duties imposed on directors and procedural rules governing shareholder litigation were identified by Armour and others[1311] as the predominant factor shaping the rate of private enforcement. Corporate governance mechanisms may also influence the level of litigation.[1312] The institutional environment of a given jurisdiction, involving factors such as the perceived expertise of the courts, judicial independence, fairness and efficiency of judicial process[1313] is also likely to play a role. Finally, different litigation rates may also be explained by the national culture.[1314]

First of all, the low rate of private enforcement in the UK and China can be partially explained by the active role played by public authorities in supervising the transactions *ex-ante* and enforcing the rules *ex-post*. Litigation in the UK is largely precluded because the enforcement of the Takeover Code is the main domain of the Panel. In case of an alleged breach of the Takeover Code, the Panel's Executive may commence disciplinary proceedings before the Hearings Committee.[1315] Only the Panel can seek injunction from the court against a party who defies a Takeover Code's provision, including target directors.[1316] Before and during the takeover bid, directors must comply with their duties under CA 2006. Although these duties are owed to the company and their enforcement is left to the company itself, shareholders can initiate claims against directors for breaches of duties on behalf of the company. Due to different substantive and procedural requirements related to derivative claims, the courts in the US are more inclined to accept the application of shareholders to sue on behalf of the company than the UK courts, which are generally hesitant to grant a permission

[1310] Since the thesis focuses on the conduct of target directors, this Part will also focus predominantly on the litigation involving target directors.
[1311] Armour and others, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States' (2009) 6 Journal of Empirical Legal Studies 687, 692.
[1312] See Goshen and Hannes' theory at n1341.
[1313] Huang, 'Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment' (2013) 61 The American Journal of Comparative Law 757, 768-9 (mentioning fairness and efficiency of judicial process as one of the most important factors in China).
[1314] See page 92.
[1315] See page 59.
[1316] See pages 77.

to continue a derivative claim.[1317] In China, in addition to the enforcement of the takeover regime by the CSRC, the target shareholders can seek enforcement of directors' duties in court though both direct suit and derivate action. The mechanism of derivative action in China is distinct from that of the US and the UK, as there are no substantive requirements for the admissibility of a derivate action. When accepting a derivative suit, the judges in China are thus only constrained by procedural requirements.[1318] Whether or not a derivative action proceeds in China is largely based on the shareholder satisfying the minimum ownership requirement (holding 1% of the company's equity for 180 consecutive days[1319]). This gives Chinese courts significantly less discretion in accepting the cases in comparison with their counterparts in the US and the UK. It may therefore seem surprising that despite such a lenient approach adopted in relation to acceptance of derivative actions there are almost no such disputes in China in relation to listed companies.

The low rate of litigation in the UK may also be attributed to the substantive rules governing the conduct of target directors. The Takeover Code's no-frustration rule constitutes a strict prohibition of any defensive tactics. As a result, there is no uncertainty as to how directors are supposed to behave when faced with a takeover, which provides less room for disputes. What is more, if there is any uncertainty regarding a specific conduct, the board is strongly encouraged to seek the opinion of the Panel, which promptly addresses such issues in the course of the bid. In the US, where defences are allowed, there is a much greater scope for uncertainty as to what conduct is acceptable under the takeover regime. This naturally generates disputes between target shareholders and corporate directors. Similarly, in China, since the scope of uncertainty is even greater than in the US, a certain level of litigation should be expected. However, the concepts of duty of care and duty of loyalty under China's jurisdiction is often considered to be too abstract to be applied to adjudication with specificity and precision,

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[1317] Although the 'proper plaintiff rule' established in *Foss v Harbottle* (1843) 67 ER 189 has been replaced by statutory shame for derivative actions, the courts remain unwilling to grant a permission to continue the claim. One of the reasons is the 'majority rule' which provides that the alleged wrongdoing can be ratified by an ordinary majority of the shareholders in general meeting. Armour, 'Enforcement Strategies in Uk Corporate Governance: A Roadmap and Empirical Assessment' (2008) 106 ECGI-Law Working Paper. For a comparative analysis of derivative claims in the UK and the US see eg Chen, *A Comparative…* (n1101) 15-52; Howson and Clarke (n767) 243, 269.

[1318] Chinese law does not contain a provision demanding the action to be brought forward in the best interest of the company. Although, Article 151 of the Company Law provides that if the firm's interests are being impaired, the shareholders may initiate a lawsuit in the court, yet the admissibility of derivative suits does not typically turn on this point. See Poologasundram, 'Investing in China? Beaware, If You Are a Minority Shareholder: How Effective Is the Derivative Action as a Protection Device for Minority Shareholders in China' (2016) 3 University of Puerto Rico Business Law Journal 332.

[1319]According to Howson and Clarke (n767) the statute does not require the shareholder bringing the claim to be a shareholder of the company at the time of the alleged wrongdoing. Poologasundram (n1318) believes that this issue remains unclear.

which may explain a low level of litigation.[1320] Obligations imposed on target directors in the context of takeover transactions are very lax[1321] and without further development of directors duties it is unlikely they will become the major force providing a meaningful protection of target shareholders' interests in China.

Different levels in private enforcement of takeover regimes can also be partially explained by the rules governing legal costs adopted by each jurisdiction. From the perspective of target shareholders, the US system is characterised by the most favourable rules, which often explains the country's high rate of private actions. Delaware follows the 'American Rule' pursuant to which each party has to cover their own litigation costs, including lawyers' fees, regardless of the outcome of the litigation,[1322] which minimises the risk for the party bringing a suit. Both the UK[1323] and China[1324] adopted the 'English Rule' which requires the losing party to bear the costs incurred by the winner. The 'loser pays all' rule does not only discourage litigation,[1325] but it is sometimes considered as the most important factor deterring M&A suits, since shareholders in big-scale cases are not willing to risk paying millions of pounds of defendants' fees.[1326] In the context of derivative actions, Delaware 'suspends' the American Rule and employs the 'common fund' doctrine instead, which provides that if litigation produces a fund benefiting an entire class of persons or an entity, the plaintiff's litigation expenses may be taken out of such recovery.[1327] Moreover, under the 'substantial benefits' doctrine lawyer's fees incurred by the shareholder bringing an action may still be recovered from a company even if there is no monetary award creating a fund as long as the court finds 'substantial benefit' to the company as a result of the suit.[1328] In the UK, plaintiff shareholders may be

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[1320] Weng (n1025) 196.
[1321] ibid 196.
[1322] It may, however, be possible to contractually modify this default rule. Inclusion of 'loser pays' fee-shifting provisions in the firm's bylaws was upheld by the Delaware Supreme Court in 2014 in *ATP Tour, Inc. v Deutscher Tennis Bund* CA No 534, 2013 (Del. May 8, 2014). Such a provision imposing liability on a losing plaintiff shareholder for the legal fees and expenses of the firm or any other party in connection with an 'internal corporate claim' constitutes an exception to the 'American Rule'. Nonetheless, a year later Delaware's legislature prohibited inclusion of the provision in the firm's constitutional documents, which was considered a shareholders-friendly decision. For more information see Frawley and others, 'Sullivan & Cromwell discusses Delaware Legislation Saying No to "Loser-Pays" Fee-Shifting Bylaws But Yes to Forum-Selection Bylaws for Stock Corporations' (*CLS Blue Sky Blog*, 16 June 2015) <> accessed 19 May 2016.
[1323] Civil Procedure Rules 1998 (SI 1998/3132), r44.3(2) (CPR).
[1324] See page 146.
[1325] Armour and others (n1311) 692, 712.
[1326] Conac and others, *Comparative Corporate Law* (West Academic Publishing 2015) 403; Hodges, *Global Class Actions Project Country Report: England and Wales* (Centre for Socio-Legal Studies, University of Oxford 2007).
[1327] Schipani, 'Corporate Governance and Shareholder Remedies: The Us Experience and Australia's Proposals for Reform' (1994) 6 Bond Law Review 28, 30.
[1328] ibid 30.

indemnified by the court for the costs incurred in the derivative suits.[1329] The outcome of the litigation has no direct impact on the granting of the indemnity, which means that even if the suit is lost, the shareholder may still be indemnified.[1330] In China, pursuant to Article 26 of the Provisions on Company Law IV the shareholder who bears the cost of derivative action may be indemnified for 'reasonable costs' by the company at the court's discretion if the claim is partially or wholly upheld. It appears that the expenses are not indemnified if the suit is lost. However, even in the case of a successful claim, it remains uncertain whether the shareholder will recover the totality of the costs incurred as it is not clear if the mentioned 'reasonable expenses' include the lawyers' fees, which often constitute a considerable part of overall expenses incurred during the proceedings[1331] (such fees are excluded from the scope of litigation costs under Article 6 of the Measures on Litigation Fees). Since the indemnity cost order has traditionally been assumed to be an effective way to financially assist shareholder plaintiffs,[1332] the uncertainty related to the funding of derivative action may be responsible for a low number of such suits in China, especially given that the remedy obtained goes to the firm, not to the shareholders incurring the costs. Minority shareholders with a small stake in the firm may therefore lack the economic incentive to protect their rights through derivative suits.

Furthermore, M&A lawyers in the US often work on the basis of contingency fees, i.e. they receive payment only if the lawsuit is successful or favourably settled. [1333] Such arrangement is believed to stimulate private enforcement.[1334] In fact, the high M&A litigation rate in Delaware is largely attributed to the existence of entrepreneurial plaintiffs' bar driven to obtain large contingency fees.[1335] Since contingency fees often amount to one-third of the award/settlement, the bar has very strong incentives to bring suits to courts. Such financial incentives are not present in the UK since the UK lawyers may not enter into agreements to receive contingency fees.[1336] Although there are no particular restrictions on advertising by lawyers in the context of group

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[1329] CPR, r19.9E.
[1330] Chen, *A Comparative…* (n1101) 41.
[1331] Jianguo and Xin, 'Cost and Fee Allocation in Civil Procedure: China National Report' (2011) 4 Tsinghua China Law Review 43.
[1332] Chen, *A Comparative…* (n1101) 40.
[1333] Schipani (n1327) 29.
[1334] Armour and others (n1311) 692, 712.
[1335] Conac and others (n1326) 402 ; Coffee Jr, 'Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working' (1983) 42 Maryland Law Review 215; Schipani (n1327) 28; Miller, 'Political Structure and Corporate Governance: Some Points of Contrast between the United States and England' [1998] Columbia Business Law Review 51, 67-68.
[1336] Conditional fees permitted in the UK do not substitute contingency fees because the maximum 'upside' allowed is a success fee amounting to 100% of hourly fees. Armour and others (n1311) 693.

litigation,[1337] the phenomenon of 'entrepreneurial lawyers' has never truly developed in the UK, likely due to the ban on contingency fees. The position of contingency fees in China is ambiguous – in theory such arrangements are not permitted under China's law, yet in practice they have been quite commonly used in securities litigation[1338]. Whilst Chen[1339] points out the lack of effective funding methods as yet another contributor to the failure of private enforcement in China, including actions against directors of listed companies, the emergence of the entrepreneurial plaintiffs' bar, which made the use of joint actions more popular in China, is often credited with the rise in securities litigation involving e.g. misleading statements that the country has been experiencing in recent years.[1340]

Recently developed by Goshen and Hannes[1341] comprehensive model based on economic theory may help to further rationalise differences in the rate of the private enforcement in a corporate context and explain its particularly low level in China, especially in relation to the listed companies. The authors argue that in the corporate litigation, the magnitude of the principal's competence (where the shareholders are principals)[1342] and the court's competence is one of the key determinants whether the parties choose judicial intervention. According to the model, shareholders with relatively low competence (such as retail investors) are more likely to use adjudication processes to solve corporate conflicts since it is the most efficient method which minimises control costs. The theory predicts that the more competent the shareholders become[1343] the less important will be the role of the courts, which in turn is set to decrease the rate of private enforcement. The rise in shareholders' competence intensifies their preference for private ordering via discretionary control rights (e.g. through proxy

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[1337] Hodges (n1326).
[1338] Huang, 'Rethinking the Relationship between Public Regulation and Private Litigation: Evidence from Securities Class Action in China' (2018) 19 Theoretical Inquiries in Law 333, 343; Palmer and Xi, 'The People's Republic of China' in Hodges, Vogenauer and Tulibacka (eds), *The Costs and Funding of Civil Litigation: A Comparative Perspective* (Bloomsbury Publishing 2010) 264.
[1339] Chen, *A Comparative…* (n1101) 31.
[1340] After a public enforcement decision is announced by the CSRC the lawyers actively 'recruit' qualified investors who invested in a firm during a specified period of time in order to file suits jointly or individually. Huang, 'Rethinking The...' (n1338) 343-4; Li Huang, "What Shapes Private Securities Enforcement in China? An Empirical Study of Chinese Securities False Statement Civil Compensation Cases" (2017) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2993634> accessed 10 March 2018, 28-9.
[1341] Goshen and Hannes, 'The Death of Corporate Law' ECGI Working Paper Series, Working Paper No 402/2018.
[1342] Control costs consist of two sub-categories: competence costs and conflict costs. Competence costs arise when the party exercising control makes an honest mistake that reduces firm value. Conflict costs, on the other hand, arise when the party exercising control takes a company's value-reducing action out of self-interest. See Goshen and Squire, 'Principal Costs: A New Theory for Corporate Law and Governance' (2017) 117 Columbia Law Review 767, 785-94.
[1343] Due to the increased institutional shareholders ownership as well as complementary market mechanisms such as hedge funds activism and existence of proxy advisors.

contest).[1344] Shareholders will resort to private enforcement only if they perceive 'adjudicatory costs'[1345] incurred through the litigation process likely to decrease the total control costs so the resolving dispute through adjudication is ultimately cheaper than through private ordering.[1346]As suggested by Buchanan and others,[1347] the monetary costs associated with proxy contest e.g. retaining lawyers and advisors, information acquisition, filing fees and solicitation of other shareholders can be substantial, adding up to USD525,070 on average in the US. The estimated price for proxy contests in the US reported by Kahan and Rock[1348] ranges between USD30,000 to USD9 million. Thus, a high rate of private enforcement may be explained by the fact that it was often more cost-effective for the shareholders of US companies to involve the court in dispute resolution rather than exercising the control rights, given dispersed ownership and collective action problems.[1349] It, therefore, appears that the country's rules regulating proxy access and proxy contests, especially the financing thereof, may be highly relevant to the Goshen and Hannes's model and to the level of corporate litigation. In fact, as observed in recent years, the decreased involvement of Delaware courts in corporate affairs has been explained to be a consequence of shareholder activism, the amplified importance of proxy advisors and higher ownership of institutional investors,[1350] which decreased the cost of private ordering.

The UK also seems to confirm the validity of the model which predicts that shareholders characterised by high competence are more likely to resolve problems themselves through the use of discretionary control rights. Corporate governance mechanisms adopted in the UK, such as reviewing and electing directors on the annual basis and the easiness of replacing directors often make it cheaper and less cumbersome to shareholders to simply exercise their entitlements by removing directors instead of suing them in court. The widespread presence of institutional shareholders combined with the relatively

[1344] Exercising control rights do generate some costs. It is assumed that shareholders (the principal) aim to minimise the sum of these costs (competence and conflict costs) to maximise the company's value. See Goshen and Hannes (n1341).
[1345] ibid 27-8 ('adjudicatory costs' also consist of competence and conflict costs. Competence cost is related to the lack of the expertise and information about the firm's business that the agents and principal possess, and conflict cost relates to judges' conflict of interest. If one assumes independent and honest judiciary the latter cost is minimal. Thus, 'adjudicatory costs' are costs borne out of the litigation process at large, not only the costs generated by judges).
[1346] ibid 30.
[1347] Buchanan and others, 'Shareholder Proposal Rules and Practice: Evidence from a Comparison of the US and UK' ('Improving Financial Institutions: the Proper Balance between regulation and Governance' Conference, Helsinki April 2012); Matsusaka and Ozbas, 'A Theory of Shareholder Approval and Proposal Rights' (2017) 33 The Journal of Law, Economics and Organization 377, 382.
[1348] Kahan and Rock, 'The Insignificance of Proxy Access' (2011) 97 Virginia Law Review 1347, 1384.
[1349] Goshen and Hannes (n1341).
[1350] ibid

low cost of exercising control rights in the UK companies make investors unwilling to use adjudication processes to resolve disputes. In contrast to the US, proxy contests in the UK listed companies are very rare[1351] as typically there is no need for them. Directors not only tend to be attentive to shareholders' opinions and interests due to the widespread presence of institutional investors, but a recent change to the UK's corporate governance regime requires the board to consult shareholders if a resolution proposed by the board attracts the 20% opposition at the general meeting.[1352] Moreover, shareholders have a statutory power[1353] to require resolutions to be included in the firm's proxy card circulated to the shareholders before the shareholders meeting, which insurgent investors may use to propose their own candidates for elections of the new members of the board. Compared to the US where the shareholders are not allowed to propose their nominees through the typical shareholder proposal regime,[1354] it represents an unusually empowering option. Similarly, to the model of Goshan and Hannes, Armour [1355] emphasises the role of private ordering which contributes to providing explanation of a low level of shareholders litigation in the UK. Since many of the corporate rules and norms in the UK have been developed with an engagement of institutional investors, the shareholders nowadays can enjoy a number of meaningful mechanisms to control directors' conduct through low-cost informal interventions.

In China, on the other hand, whilst the controlling shareholders can easily resort to the control rights to resolve disputes at relatively low cost as the company law greatly empowers shareholders,[1356] minority shareholders are often unable to seek enforcement through private ordering mainly due to the various obstacles created by concentrated ownership structure and certain corporate governance mechanisms. Although still relatively rare as compared to the US, proxy contests are becoming more popular in China.[1357] Since qualified shareholders can submit a proposal for voting in the general meeting,[1358] activist investors of Chinese firms can propose their own candidates for the election of new directors if the current members of the board appear unsatisfactory. However, as Junhai

[1351] Moore and Petrin, *Corporate Governance: Law, Regulation and Theory* (Macmillan International Higher Education 2017) 86.
[1352] See page 64.
[1353] See page 62.
[1354] See page 31; Moore and Petrin (n1351) 87.
[1355] Armour and others (n1311) divided enforcement into informal public, formal public, informal private, formal private.
[1356] See Part 5.4.
[1357] Holthuis, Jiao and Liu, 'Shareholder Activism in China' *Practical Law* (01 February 2018) <https://uk.practicallaw.thomsonreuters.com/w-013 1127?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1> accessed 10 August 2018.
[1358] See page 107.

Liu[1359] noted, the cost of being organised is often very significant in China. Incentives of minority shareholders to take the risks of engaging in activist actions are limited because there is lack of mechanism to reimburse expenses incurred by shareholders conducting a proxy contest when the benefits are shared by all shareholders.[1360] Moreover, even if the activist investor does take initiative to exercise the control rights, the case of Baoneng's proposal to replace directors shows that the incumbent board has a relatively broad discretion to sabotage such action.[1361] In accordance with the Goshan and Hannes's model, minority shareholders should therefore choose to engage the courts in dispute resolution. However, the adjudicative costs in China are likely to be perceived by such shareholders as very high since both the competence costs (the Chinese courts lacking expertise and experience in adjudicating corporate disputes)[1362] and the conflict costs (the courts lacking impartiality and impaired fairness of the court proceedings),[1363] on top of the usual litigation and lawyers' fees, tend to increase the overall adjudicatory cost. This may be the reason why minority shareholders in China's listed firms, who often are individual retail investors with a small stake in the company, usually prefer to sell their shares rather than exercise control rights or initiate legal proceedings against directors. China's shareholders, as explained by Hirschman,[1364] exercise their entitlements mainly through 'exit' strategy. This is consistent with the account provided by Dan Wang[1365] who attributed the low level of private enforcement in China to the identity and the characteristics of minority shareholders. Holding a very small fraction of the company's equity, China's minority investors tend to trade shares to make 'quick money', which makes them uninterested in the company's corporate governance. If the company's financial performance is not good enough, they simply retract their money and invest them elsewhere.

Moreover, is has been recognised that the country's cultural aspects may affect how shareholders decide to resolve issues involving directors' duties.[1366] Morley

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[1359] Liu, 'Improving Investor-Friendly Legal Environments in the Chinese Capital Market' in Howson and Huang (eds), *Enforcement of Corporate and Securities Law: China and the World* (Cambridge University Press 2017) 163, 169.
[1360] Holthuis, Jiao and Liu (n1357).
[1361] Kruszewska, 'Target Board's…' (n931).
[1362] See page 146.
[1363] ibid
[1364] 'Exit' simply means selling the shares, while 'voice' can be exercised through shareholders' decisions rights and director's removal from the firm. Hirschman, 'Exit, Voice and Loyalty: Further reflections and a Survey of Recent Contributions' Milbank Memorial Fund Quarterly.
[1365] Wang, 'Theoretical Analysis of Shareholders' Derivative Actions' [2012] China Law Publishing House.
[1366] Eg de Vera, 'Arbitrating Harmony: Med-Arb and the Confluence of Culture and Rule of Law in the Resolution of International Commercial Disputes in China' (2004) 18 Columbia Journal of Asian Law 149.

describes litigation culture as the features of a particular culture including acceptability of litigation and attitude towards litigation that might explain the rate of private enforcement in a given jurisdiction.[1367] With an ideology of scepticism towards the competence and neutrality of public authorities and positive attitudes towards litigation, the US has long been seen as a country with a very strong focus on private enforcement.[1368] The UK, in contrast, is generally considered to be 'less litigious, but not un-litigious'.[1369] It is perhaps the result of a concentrated rather than diffused state power and the active role of the public authorities (such as the Panel) and private parties' trust in their process to enforce laws and policies.[1370] China is commonly seen as a country with a litigation-averse culture[1371] due to its deeply embedded emphasis on maintaining social harmony.[1372] Such unlitigious attitude of Chinese society is manifested in an observed preference of mediation over legal proceedings,[1373] and has been listed as one of the possible reasons behind limited private enforcement by China's shareholders along with the insufficient awareness of the plaintiffs' own rights.[1374] While cultural factors may be useful in understanding and explaining the low rate of takeover litigation in China, ever-increasing economic globalisation and internationalisation of investment makes the national culture as a factor less relevant. Regardless of social attitudes towards litigation, China's legal system also contains provisions that may discourage shareholders' private enforcement. For example, the courts are instructed to place emphasis on mediation and encourage the parties to reconcile with each other.[1375] To additionally reinforce such behaviour, litigation charges are reduced by 50% for actions closed through mediation or by withdrawal of the complaint.[1376]

[1367] Morley (n1195) 220-1.

[1368] Reimann, 'Private Enforcement in the United States and in Europe' in Howson and Huang (eds), *Enforcement of Corporate and Securities Law: China and the World* (Cambridge University Press 2017), 32.

[1369] Armour and others (n1311) 689.

[1370] Reimann (n1368) 36.

[1371] Chen, *A Comparative…* (n1101) 102; Huang, *Securities and...* (n1061) 5 (citing results of empirical studies which indicated that a litigation-averse culture, along with high litigation costs, delayed civil proceedings and insufficient awareness of the plaintiffs' own rights are possible reasons behind the low rate of private enforcement in China); Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27 Banking and Finance Law Review 619.

[1372] Lin, 'The Chinese Socio-Cultural Influence on the Legal System of the People's Republic of China and Its Implications for Foreign Investment: A Critical Analysis' (DPhil Thesis, University of Wollongong 2011).

[1373] ibid; Poologasundram (n1318).

[1374] Huang, *Securities and...* (n1061) 5.

[1375] 2003 SL Provisions (n1055), art 4.

[1376] Measures on Litigation Fees (n1090), art 15.

6.8. Sources of Convergence and Divergence

6.8.1. General Corporate Regime

According to MacNeil,[1377] China's legal framework for corporate regime demonstrates substantial evidence of high level of convergence with international standards. The main source of the convergence is deliberate adoption of foreign standards through legal transplantation by China's lawmakers. Such decision was driven by multiple motives with a need to signal China's 'modernity', to comply with the requirements imposed by global capital markets, and a desire to provide assurances and confidence in China's capital markets to uneasy private investors being among the most relevant ones.[1378] The formal process of corporatisation constituting the core element of the reform, was also motivated by pursuit of development and efficiency improvements of the Chinese immature market 'in an orderly way'.[1379] When analysed against the background of the systemic inefficiency,[1380] the impact of the 1997 Asian financial crisis which exposed structural weaknesses inherent in China's corporate governance,[1381] as well as extensive reforms of SOEs,[1382] the efficiency motive behind the adoption of the particular corporate regime seems very persuasive.

It would be difficult to claim that China has achieved desired outcome of increased efficiency despite numerous ostensible similarities between its corporate regime and those of the UK and the US. If one, however, analyses China's regime in greater detail, it becomes apparent that seemingly small deviations from the foreign rules and the unique socio-economic context in which the rules operate made a tremendous difference. This is the reason why formally 'shareholder-centric' model of corporate governance in China is not necessarily 'shareholder-oriented'.[1383] Thus, it must be stressed that the observed convergence discussed above is formal, rather than functional what translates to different operation of the ostensibly similar regimes in practice. Resistance in functional convergence can often be attributed to the various forces

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[1377] MacNeil, 'Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies' (2017) 2 Journal of Corporate Law Studies 289 . Also see Howson, 'The Doctrine That Dared Not Speak Its Name: Anglo-American Fiduciary Duties in China's 2005 Company Law and Case Law Intimations of Prior Convergence' in Kanda, Kim, Milhaupt (eds) *Transforming Corporate Governance in East Asia*, (London: Routledge 2008)193.

[1378] Howson, 'The Doctrine...' (n1377).

[1379] Cai, 'The Mandatory...' (n812) 652.

[1380] ibid 671.

[1381] Cheung and others, 'Corporate Governance and Firm Valuation in Asian Emerging Markets' in Boubaker and Nguyen (eds), *Corporate Governance in Emerging Markets* (Springer 2014) 30-33.

[1382] Such as the split-share reform and the 'grasping the small…' reform discussed at pages 105 and 104 respectively.

[1383] See discussion at page 173 .

of path-dependency. The theory of path-dependency, originally developed by Roe and Bebchuk,[1384] is based on the proposition that the ability of a system to adapt and evolve is limited by certain structures existing in the system from the onset.[1385]

Path-dependency is very often strengthened by the groups with a vested interest in opposing or moderating reform because they benefit (e.g. in the form of extracting economic rents) from the status quo. Bebchuk and Roe propose a concept of 'rent seeking' and 'rent protection', arguing that those with a controlling position may pressure the regulators not to pass rules which would reduce their private benefits even if such provisions helped to enhance firms' value.[1386] In China the state as a shareholder tends to act in such way to protect its control over the national economy. The extensiveness of state control as well as its prevalent presence in the corporate structures of listed firms differentiate China from the UK and the US. As discussed earlier,[1387] the percentage of the state as an ultimate controller in China's listed firms is drastically higher than in the other two analysed jurisdictions. The widespread state ownership in China is the result of the political economy - since the process of 'corporatisation' initiated in 1980s had not implicated privatisation or any genuine withdrawal of the state from the corporate world,[1388] the government (and the CPC behind it) still retains broad control over converted firms not only in the sectors related to national security or key infrastructure but also in many non-related sectors.[1389] Despite selling off a significant portion of state shares to the public in the SSS reform[1390] central and local governments continue enjoying control over listed firms financed with the aid of private investors. Even the 'mixed ownership' reform which introduced a substantial amount of private equity to the SOEs did not fundamentally alter the government-SOEs dynamics.[1391] Yet the tentacles of the state in China are spread well beyond SOEs. They reach far into the private sector where government is able to exert significant control even over firms in which it has no equity interest. The first mechanism of influence is through financial support. Subsidies and access to preferential borrowing terms to large and fast-growing private companies are very common and often comprise a

[1384] Bebchuk and Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 Stanford Law Review 127.
[1385] According to path-dependence theory, the corporate structures at any point in time will be determined by those that existed at the outset, and that corporate rules which influence ownership will also depend on those initial structures.
[1386] Bebchuk and Roe (n1384) 137-9.
[1387] See page 153.
[1388] See page 105.
[1389] Howson, 'Quack Corporate...' (n763).
[1390] See page 106.
[1391] Milhaupt and Zheng (n1157).

major portion of a company's financing.[1392] Political networking linking the state and private sectors individuals constitute another instrument of influence. Empirical research by Milhaupt and Zhang shows that the founders and senior executives of top firms from China's private sector are closely connected to government and the CPC.[1393] Last but not least, government often exercises extra-legal control over private firms, for example through the practice of regulators conducting 'interviews' with the executives to encourage or compel compliance with policies favoured by the state.[1394]

The changes introduced pursuant to the reforms in principle threaten to weaken state control over market participants and national economy. The state, unwilling to give up all its influence, sought means by which it could retain some level of control. When the corporate governance system adopted by China is projected onto the realm of socio-political and institutional environment it is not surprising that, at least for the time being, it is the state through the companies' shareholders meeting who is the central actor and the main beneficiary of corporate governance in China rather than the shareholders themselves as envisaged in the Company Law. As a result, formal convergence in legal rules co-exists in China with divergence in the functioning of the corporate regime in practice.

Moreover, functional divergence can also be explained by substantial differences in the level of concentration of corporate ownership between the analysed jurisdictions, with China sitting on one side of the spectrum and the US and the UK sitting on the other. Even identical rules placed in such a different settings will inevitably produce different results.

6.8.2. Takeover Regime

The seminal work by Armour and Skeel[1395] addressing the possible reasons for divergence in takeover rules demonstrates how different historical, economic, legal and political factors affected the shape of two takeover regimes. The authors identify that it is the mode of regulation i.e. the role and interests of lobbying groups and the identity of the regulator that determines to a great extent the content of substantive rules. Thus, in the UK, whose capital markets have been dominated by institutional investors, self-regulation led to the regime driven by the interests of shareholders.[1396] Yet, it is important to note that Kershaw takes a different position on development of the UK's takeover regime

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[1392] ibid
[1393] ibid identified that the founder or *de facto* controller in 95% of the top private firms and 80% of the top high-tech internet companies is or was a member of central or local political organisation.
[1394] ibid
[1395] Armour and Skeel Jr (n442).
[1396] Armour and Skeel Jr (n442).

arguing that its pro-shareholder approach was predominantly driven by the merchant banks that had an interest in rules facilitating active market for corporate control.[1397] The non-frustration rule which allows shareholders to decide on the merits of the bid and prohibits the target board to use defensive measures is one of such rules. Moreover, it has been argued that an effective self-regulation is a result of a desire of the City institutions to control the regulatory action over takeovers rather than being susceptible to regulation by the state. Kershaw also argues that the non-frustration rule has become one of the 'keystone rules' of the Takeover Code to allow the Panel (and indirectly – the City institutions) to control takeover activities in the UK. If there was no strict prohibition on the use of post-bid takeover defences, then the power would be placed in the hands of the courts adjudicating cases and interpreting the scope of application of the existing company laws including e.g. the proper purpose doctrine.[1398]

On the other hand, the US' judicial law-making benefited executives and made it rather difficult for shareholders to influence the rules, since its capital markets at the time was generally characterised by the great proportion of retail investors and a mistrust of the 'insiders' controlling securities institutions. Moreover, it is often argued that rather than being adopted because it constituted the most optimal rule, Delaware's board discretion rule is a product of the state competition and the so-called 'race to the bottom' phenomenon. Based on the premise that it is the executives[1399] who influence decisions regarding the place of incorporation and reincorporation, many[1400] argue that Delaware's rules governing corporate affairs in general and hostile takeovers in particular were influenced by desire to compete with other states to attract (re)incorporations

[1397] Kershaw, *Principles of Takeover Regulation* (n445) opinion that development of the UK's takeover regime has been predominantly driven by merchant banks.
[1398] ibid.
[1399] The main decision-makers in domicile decision at the time of incorporation and anytime afterwards (reincorporation) should be distinguished. The main decision-maker at the incorporation stage is the owner-manager/founding shareholders, depending on the firm's initial governance arrangements. Thus, there is often no separation of ownership and control, no collective action problems and no agency costs at that time. The opposite can be said about the firm at the time of reincorporation. Although the ultimate decision-makers on reinterpretation to a different state are shareholders, the executives are heavily involved in the process because it is the board of directors that brings the proposal on reincorporation for the shareholders to vote on. Thus, while public corporations making decisions to reincorporate may make suboptimal domicile decisions, it is less likely that the parties responsible for incorporation decisions will search sub-optimal rules. It should be noted that Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985) 1 Journal of Law, Economics, and Organization 225 found that reincorporation decisions were typically motivated by lawyers rather than executives. Daines's study showed that law firms that are employed by the firm at the time of IPO have a very significant effect on its choice of incorporation. See Daines, 'The Incorporation Choices of Ipo Firms' (2002) 77 New York University Law Review 1559, 1575.
[1400] Eg Bebchuk and Cohen, 'Firms' Decisions Where to Incorporate' (2003) 46 The Journal of Law and Economics 383; Cary, 'Federalism and Corporate Law: Reflections Upon Delaware' (1974) 83 Yale Law Journal 663; Bebchuk and Ferrell, 'Federalism and Corporate Law: The Race to Protect Managers from Takeovers' (1999) 99 Columbia Law Review 1168.

without having much regard whether the rules adopted were the most beneficial for investors. Proponents of the 'race to the bottom' theory thus believe that lawmakers favoured the interests of the board of directors, often at the expense of the shareholders.[1401] Many academics,[1402] nonetheless, see the competition for corporate charters as 'race to the top' rather than 'race to the bottom' claiming that states' aspiration to attract (re)incorporations induces them to develop corporate laws enhancing shareholder value. Bebchuk[1403] dismissed some of the arguments central to the 'race to the top' theory concluding that none of them significantly influence directors' decisions in favour of choosing to (re)incorporate in states that offer regulations enhancing shareholder value. On the other hand, Roe claims[1404] that Delaware's relatively executive-friendly takeover regime cannot be fully explained by neither of the presented theories. Rather than simply being a product of state competition for corporate charters, it is in part an outcome of federal influence which constrains the states by enacting the pre-emptive federal law if they go too far in catering for directors' and their own interests.

The above discussion aligns with Miller's argument that the main source of differences in takeover regulations rests in diverse political structures.[1405] The American state-based system makes it easier for political forces to influence the courts and state governments to develop regulations discouraging takeovers, which e.g. resulted in enacting various antitakeover statues. In contrast to the state-based corporate law in the US, a more unitary system in the UK tends to produce rules which cater the needs of the capital markets' participants.

Discussion of general corporate regime in Part 5.4 and the framework developed by Armour and Skeel may be used to explain China's approach to regulation of directors conduct in the takeover context. Initially, it was the State Council that enacted regulations governing China's early takeover activities. The first takeover regulation - the Issuing and Trading Shares Provisions[1406] from 1993 were heavily based on the HK Code which itself was modelled on the UK's Takeover Code.[1407] While the Issuing and Trading Shares Provisions included

[1401] Romano, 'Law As…' (n1399)
[1402] Eg Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1996); Winter Jr, 'State Law, Shareholder Protection, and the Theory of the Corporation' (1977) 6 The Journal of Legal Studies 251; Armour and Skeel Jr (n442) 1747.
[1403] Bebchuk and Ferrell (n1400)
[1404] Roe, 'Delaware's Competition' (2003) 117 Harvard Law Review 588.
[1405] Miller(n1335) 69-70.
[1406] Issuing and Trading Shares Provisions (n811).
[1407] See page 91.

provisions regulating MBR,[1408] disclosure requirements,[1409] the principle of fair price[1410] and fair treatment of shareholders,[1411] the conduct of directors in the takeover context has been left largely unregulated. At that time, China decided not to transplant the restriction on frustrating actions by the board which could be found in the HK Code as one of its general principles[1412].

The power to issue a complete set of takeover rules was given to the CSRC which, in 2002 acting via administrative regulations, issued the Takeover Measures which included provisions governing the board's conduct in M&A transactions. The 2002 Takeover Measures outlined the role of the target directors which, although not being a direct copy, loosely resembled the UK's (and, nearly identical, Hong Kong's) board neutrality rule. The CSRC was given extensive power to develop the takeover regime in China because of the limited technical competence of Chinese legislators at the NPC level with respect to this area. The CSRC with its expert knowledge was being trusted to be capable of drafting substantive rules governing capital markets.[1413] Chao Xi therefore claims that China's regime is an outcome of a well-informed and rational law-making process by the CSRC which included e.g. conducting a comparative research of various civil and common-law jurisdictions,[1414] of which the best turned out to be the regulations adopted by the UK and the US, which then served as the main inspiration for developing China's takeover regime. Whilst it can be assumed that the process of formulating the Takeover Measures was informed, it cannot, however, be presumed that the outcome was entirely based on the complete cost/benefit analysis since the impact of the Anglo-American tradition has been largely institutionalised and channelled through the roles of key individuals such as Gao Xiqing[1415] and Laura Cha[1416] - the then vice-chairpersons of the CSRC who were educated in the US.[1417] Indeed, the legislative process of the 2002 Takeover Measures was marked by disagreement

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[1408] Issuing and Trading Shares Provisions, art 48.
[1409] Ibid, art 47.
[1410] Ibid, art 48.
[1411] Ibid, art 50.
[1412] Chou, 'Corporate Takeovers in Hong Kong. Case Study – the Hong Kong and Shanghai Hotels (Research Report, Chinese University of Hong Kong, 1990) <https://core.ac.uk/download/pdf/48543825.pdf> accessed 30 November 2019.
[1413] Howson, 'Quack Corporate...' (n763) 667, 709.
[1414] Xi, 'The Political Economy of Cumulative Voting: The Case of China' (2014) 14 The Asian Business Lawyer 61, 61-72.
[1415] A vice-chairperson of the CSRC during the period of 1999-2003.
[1416] A vice-chairperson of the CSRC during the period of 2001-2004.
[1417] Xi and Pan, 'Public Enforcement of Securities Laws' in Zhao and Ng (eds), *Chinese Legal Reform and the Global Legal Order: Adoption and Adaptation* (Cambridge University Press 2017), 82; Hutchens (n1042) 673.

between the supporters of the UK's system and those favouring the US approach to takeover regulation.[1418]

Guanghua Yu[1419] went a step further claiming that China's takeover regime can be explained by 'chaos theory' which assumes that certain developments are the result of historical events, rather than a rational process based on the careful cost/benefit analysis. One of the main reasons for adoption of the 'relaxed' board neutrality rule may therefore be the familiarity with the UK-modelled regime adopted in the predecessor of the Takeover Measures – the Issuing and Trading Shares Provisions which familiarised Chinese regulators with many of the other provisions of the UK's Takeover Code.[1420]

Moreover, as mentioned in Part 5.3, around the time of many business-related law reforms back in the early 1990s/2000s, China aimed to utilise the HKSE for the capital needs of its corporations. Thus, the initial adoption of the 'relaxed' board neutrality rule can also be considered a consequence of the Hong Kong-focused policy. Hong Kong, with its laws and regulations modelled on the UK laws (including board's neutrality rule), had great leverage to induce China to adopt the regime which Hong Kongese investors were familiar with, and which China, since it needed capital, was willing to implement. As noted by Chao Xi, Hong Kong's impact has also been apparent through highly influential senior professionals and members of the Hong Kong's securities regulatory authority whose role was to advise China on the issue of takeovers' regulation,[1421] which significantly contributed to China's adopting the board neutrality regime. Indeed, one of the possible reasons behind the ambiguity and under-inclusiveness of the original Article 33 of the 2002 Takeover Measures may be a direct, yet not exact (and rather thoughtless) transplantation of part of Rule 4 of the early version of the HK Code which contained the rule on non-frustration. It confirms Guanghua Yu's claims, that the transplantation of the UK's model of takeover regulations can be described as 'accidental' rather than the result of cautious cost/benefit analysis.[1422]

The chaos theory offers a plausible explanation of China's adopting the takeover regime which in many areas resembles the provisions from the UK's Takeover Code, especially given China's need to raise capital by listing shares of China-incorporated firms on HKSE at the beginning of 1990s. Yet it must not be

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[1418] Xi, 'The Political Economy of Takeover Regulation: What Does the Mandatory Bid Rule in China Tell Us?' [2015] Journal of Business Law 142, 157.
[1419] Yu, 'Takeovers In...' (n890) 179-80.
[1420] ibid 190.
[1421] Xi, 'The Political...' (n1418) 145.
[1422] Yu, 'Takeovers In...' (n890) 175.

overlooked that China has not transplanted a strict board neutrality rule directly – the rule contained in 2002 Takeover Measures was not the same as those found in the takeover codes of the UK and Hong Kong,[1423] which then were nearly identical. This suggests that China deliberately diverged from this model of takeover regime, specifically with regard to the board's conduct in takeover transactions. It would be consistent with the Chao Xi's argument pursuant to which China's Securities Law and Company Law are the outcome of an informed and comprehensive process. Of course, the final result of the process employed by the CSRC when developing the Takeover Measures may not necessarily be the most efficient one due to the extensive influence of the pressure groups driven to protect their vested interests, often at the expensive of the efficiency of the system. It, nevertheless, cannot be claimed that the transplant of the takeover law in China was completely accidental.

With the relative freedom to draft the takeover regulations, Chao Xi suggests that the CSRC decided to grant itself a central role in the Chinese market for corporate control, reserving not only enforcement authority but also the power to influence M&A transactions through e.g. its right to wave the MBR requirement.[1424] Thus, prohibiting the board from using anti-takeover measures may also have its roots in the CSRC's own institutional interest. By selecting the rule that minimises the involvement of the judiciary in the takeover regime, it undermined the role courts would play in the change of control transactions, which allowed the CSRC to increase its power by 'monopolising' jurisdiction over takeover transactions. On the other hand, both Howson[1425] and Chao Xi[1426] argue that the CSRC designed China's corporate regime in a way to reduce involvement of the judges in its enforcement because the securities regulator considered the courts' competence and independence insufficient. Indeed, Xin Zhang, who was one of the primary drafters of the Takeover Measures explains that adoption of the US approach was not suitable because, among others, China lacked courts, judges and legal professionals capable of dealing with complex M&A activities.[1427] It is, therefore, very plausible that the relaxed board neutrality rule was chosen to govern the conduct of directors, as the prohibition of post-bid defences would minimise the courts' role in takeover regime. The

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[1423] Observation of Varottil and Wan (n21) 19 regarding China's board neutrality rule confirms observation of the author.
[1424] Xi, 'The Political...' (n1418) 147.
[1425] Howson, 'Quack Corporate...' (n763) 695.
[1426] Xi, 'The Political...' (n1418) 159.
[1427] Zhang Xin [Zhang],'Shangshi Gongsi Shougou de Lifa He Jianguan—— Women Weisheme Bunnng Caiqu Meiguo Moshi?' [Regulation of Acquisitions of Public Companies: Why We Cannot Adopt the American Model] (2003) 8 Zhengquan Shichang Daobao [Securities Market Herald], <http://finance.sina.com.cn/financecomment/20040825/1905975679.shtml> accessed 17 March 2018.

alternative theory suggests that the limited involvement of the courts and the major role of the public enforcement under China's takeover regime is the result of the state's resistance to any constraints on its ability to operate public companies as a controlling shareholder, especially in the areas of restructuring. It is interesting to see that this theory of political influence closely resembles Kershaw's argument regarding the role of the strict non-frustration rule in the UK as a 'keystone rule' of the Takeover Code discussed above[1428].

Minimising the involvement of the target board in the takeover transactions may also be a result of the need for regulations which would facilitate takeover activities. China's securities and corporate regimes were initially established mainly for the benefit of the SOEs - to rescue them and improve their performance.[1429] The takeover regime developed by the 2002 Takeover Measures, which took place during the country's ongoing corporatisation process, was highly instrumental, designed mainly to fulfil the needs of the state with the aim to facilitate restructuring and provide financing to inefficient firms.[1430] Then in 2006, when the Takeover Measures were first amended, there was a shift in the approach to industrial restructuring which moved from being mainly administrative-oriented to one with a significant role for capital markets.[1431] China's industrial restructuring then focused on scaling up industrial concentration and creating 'national champions' in strategic sectors. The concentration of smaller companies in the same industry into a large, globally competitive conglomerates was directed by the government,[1432] while the capital and securities markets were allocated a central role in the implementation of China's industrial policy.[1433] This involved facilitating acquisitions by creating a takeover-friendly regime and prohibiting anti-takeover measures.

The rent-seeking theory used to explain the framework and functioning of China's corporate regime generally may also be helpful to understand the takeover provisions adopted by the CSRC. Around the time of enactment of the 2002 Takeover Measures, the state held overall about two-thirds of the total

[1428] See page 197.
[1429] See pages 104-106.
[1430] Yu, 'Takeovers In...' (n890) 176.
[1431] Xi, 'The Political...' (n1418) 161.
[1432] ibid 161.
[1433] ibid 163.

market capitalisation[1434] and 77%[1435] of firms with a concentrated ownership had the state as a controlling shareholder. The central SOEs, thanks to the extensive connections,[1436] were capable of effectively lobbying the law-making authorities at the national level.[1437] Many of central SOEs enjoyed greater political influence than the CSRC itself, which gave them leverage over the securities regulator**.**[1438] Since the state's main political goal in relation to capital markets was to maintain control over state-owned assets in the process of firms' restructuring,[1439] it appears that it may have had an interest in empowering shareholders both in general and in the context of takeovers. This may explain why the CSRC restricted the scope of actions available to directors when faced with a takeover bid while granting extensive rights to shareholders, especially providing them with decisive authority on making a decision whether to accept a bid.

Last but not least, differences in takeover rules may also be explained by the challenges and concerns which they have been enacted to address. One may thus argue that the CSRC chose not to adopt the US-style board discretion rule because of its motivation to minimise agency problems between the controlling and minority shareholders. Aware of the fact that directors of the majority of Chinese firms respond to the controlling shareholder, the securities regulator opted to restrict the role of the board in takeover transactions to limit the possibilities of it making decisions primarily serving the interests of the controller. Since China's aimed to attract capital from Hong Kong,[1440] one of the emphasises of the official CSRC's policy has been on minority shareholders protection, giving all shareholders a say on whether to accept or reject a tender offer was in line with this rhetoric. Allowing the board to defend the company against hostile suitor would be the same as giving only the controllers the ultimate right to decide on the offer, which would deny minority shareholders the chance to exit the company and sell their shares at a premium. The relaxed board neutrality rule adopted by China, even if not as strict as in the UK, was

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[1434] Wang and Xu, 'What Determines Chinese Stock Returns?' (2004) 60 Financial Analysts Journal 65, 69.

[1435] A research conducted in 2002 by the CSRC found that of 1,015 controllers in the 1,175 listed firms 77% could be considered state organs. See Wang, 'Governance Role of Different Types of State Shareholders: Evidence from China's Listed Companies' (DPhil Thesis, Hong Kong University of Science and Technology 2002).

[1436] Top executives of these SOEs get promoted to senior leadership positions at the State Council and its ministries, as well as in the provinces. Xi, 'The Political...' (n1418) 153.

[1437] Tong, 'A Look into Protection of Preferred Stockholders' Rights under the Context of State-Owned Enterprise Reform' (2016) 4 Peking University Transnational Law Review 208; Xi, 'The Political...' (n1418) 153.

[1438] Xi, 'The Political...'(n1418) 153.

[1439] Yu, 'Takeovers In...' (n890) 185-90.

[1440] See page 91.

also consistent with the perceived national interest, that is, a shift towards a regime which would increase investors' confidence and attract much needed capital through securities markets. In the early years of 2000, after the publication of the influential work of La Porta and others[1441] indicating the correlation between the investor protection and capital-raising, both the securities and corporate regimes have been gradually moving towards better minority shareholder protection as China aimed to inject more capital to its listed firms from domestic and foreign investors. Moreover, the protection of investors' rights would also help to develop the capital markets themselves, whose role become central to facilitation of industrial restructuring.

Whilst it appears that the adoption of relaxed board neutrality rule to protect minority shareholders is contrary to the theories of path-dependency and that of the dominant interest group, it may not necessarily be the case, as the state as a shareholder was likely to be indifferent as to which rule was implemented as neither of those options left the target firm in which the state holds its shares vulnerable. Having the majority of the firm's shares allowed the state to decide whether or not the bid for a specific company would succeed. Thus, it was extremely unlikely that any valuable SOE would be taken over against the will of the state as a controller. Furthermore, even if a certain firm had dispersed ownership structure and thus was susceptible to an unwanted acquisition, but the state considered it valuable to the national economy, the CSRC could easily step in and influence the outcome of the offer as it retained the power to assess the merit of any takeover either through the system of mandatory administrative review[1442] or the right to wave a requirement of launching the full (and therefore very expensive) offer[1443]. Thus, adopting the board neutrality rule remains consistent with the preferences of the dominant interest group and with the state's political goal of maintaining control over state-owned assets. Furthermore, it is also in line with the claims made by Ventoruzzo[1444] who, after having analysed the takeover rules in the EU Member States, demonstrated that the adoption of the UK-style neutrality rule in a jurisdiction with concentrated ownership does not protect interests of the shareholders. Instead, it allows the controlling shareholder via the board of directors to resist unwanted acquisition by using frustrating mechanisms whilst presenting a smaller risk in terms of liability for the firms' directors as they do not need to employ any actions which

[1441] La Porta and others, 'Investor Protection and Corporate Valuation' (1999) 57 Harvard Institute of Economics Research Paper No 1882.
[1442] The system does not exist since 2014.
[1443] Many bidders had not had sufficient funds to launch a full offer therefore not waving the MBR was often equal to frustration of the bid.
[1444] Ventoruzzo (n1138).

could attract civil litigation. In China where the majority of firms have a controlling shareholder and the shareholder meeting is the most powerful organ in corporate governance, the rule initially adopted in the Takeover Measures could in fact be assumed not to protect minority shareholders, but rather to enhance the interests of the controllers - in this case, the state.

6.9. Pros and Cons of the UK and the US Takeover Regulations

The non-frustration rule is a manifestation of shareholder sovereignty embedded in the UK's company law.[1445] The clear advantage of a rule of strict neutrality is its transparency, predictability and the fact that it captures the principle of shareholder decision-making. Such an approach equips shareholders, who are presumed to be competent investors capable of making investment decisions, with a choice regarding the future of their stake in the firm. It also provides a method for shareholders to exit the firm on acceptable terms if a takeover bid occurs. Furthermore, removing the board from the transaction's equation handles an inherent conflict of interest associated with hostile acquisitions by effectively limiting directors' opportunities for self-serving decisions taken in relation to a specific bid.[1446] This policy choice seems to be based on the 'management entrenchment theory'[1447] which suggests that directors are prone to use defensive tactics to ensure their longevity with the company.

The US' board discretion rule likely assumes the validity of the alternative 'shareholder interest theory', which claims that the regime prohibiting the use of takeover defences harms the interest of shareholders because it deprives the target board of a full-scale role in protecting shareholders from coercive offers or negotiating bids on shareholders' behalf. The core argument in favour of the board discretion rule is the idea that acceptance or rejection of a takeover bid is no different to any other important business decision, so it is the board which should make such decision and the BJR should be applied in reviewing it.[1448] On the other hand, permitting the company to adopt antitakeover mechanisms if the board considers the offer inadequate, allows the target directors to substitute their judgment of the bid's adequacy for the shareholders' judgment, thus it simply deprives shareholders of the basic freedom to dispose of their shares as they wish[1449] and is almost, therefore, an expropriation.

[1445] Davies, *Gower and Davies' Principles of Modern Company Law* (Sweet & Maxwell 2003) 709.
[1446] Gilson, 'A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers' (1981) 33 Stanford Law Review 819.
[1447] DePamphilis (n980) 98.
[1448] Lipton, 'Takeover Bids in the Target's Boardroom' (1979) 35 The Business Lawyer 101 120.
[1449] Ritter (n348).

Assuming that takeovers are beneficial for the economy by providing a means to efficiently allocate scarce resources,[1450] the UK's regime offers a method which allows resources to be freely available for an optimal allocation in the economy. The board's neutrality rule makes it more difficult for directors to resist value-enhancing bids driven by the potential benefits of introducing a new board to the target firm which will use the resources more efficiently. Thus, the absence of such rule may not only reduce shareholders' wealth but also harm the economy in general since resources are not being put to their most productive use.[1451] Whilst the US's regime at the federal level is designed to be neutral in order to allow as many value-enhancing takeovers as possible, the board discretion rule adopted at state level hinders the efficiency of the regime as even potentially value-enhancing offers may be frustrated for practically any reason. Even if the board's resistance is motivated by the company's interest e.g. when it has certain non-public information against the takeover[1452] or it genuinely believes the bid price is inadequate, there is a risk that the judgement of the board may well be wrong.[1453] Both shareholders of the specific corporation and the economy as a whole may therefore lose as a result.

The other main argument in favour of an unrestricted market for corporate control is the disciplining role of hostile takeovers and their ability to limit agency costs. The UK's neutrality rule facilitates both monitoring and disciplining roles of takeovers for the benefit of all shareholders as it provides protection against the board's misconduct and self-dealing exercised in the ordinary course of business. Easterbrook and Fischel[1454] argue that if the decision is left to the board, its personal interest in self-preservation would too often overcome its commitment to act in the best interests of the shareholders. Thus, the US-style board discretion rule permitting the use of defences significantly limits the disciplinary effect of takeovers. While in the UK the role of the takeovers in replacing the board is not particularly important as directors can relatively easily be replaced at the AGM or removed by the general meeting, the deterrent effect may nevertheless benefit firms. Since, however, some corporate governance mechanisms such as annual evaluation of the board or requirement to consult shareholders when board-proposed resolutions attract 20% opposition[1455] function as an internal monitoring device in the UK, the external deterrence effect of takeovers may not be indispensable to keep the

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[1450] For detailed discussion on the effect of takeovers see Part 1.5.2.
[1451] DePamphilis (n980) 92.
[1452] Ragazzo, 'The Legitimacy of Takeover Defense in The'90s' (1992) 41 DePaul Law Review 689, 729.
[1453] Romano, 'A Guide…' (n98) 150.
[1454] Easterbrook and Fischel (n57) 1177, 1175.
[1455] See Part 3.3.3.

board disciplined. On the other hand, in jurisdictions such as the US and China where the longer terms of the board of directors are allowed or where it is difficult to remove a director/replace the board, the active market for corporate control and the neutrality rule could play a considerably more important role and straightforward prohibition of defensive mechanisms would be a relatively cheap and effective method of disciplining directors. The results of a study conducted by Nuttall[1456] on the actual impact of UK's takeover market on the performance of listed companies showed that the risk of hostile takeover does not have a significant effect on firm's productivity, but it increases dividend payment, which is positive as paying greater dividends by the board helps to reduce spending corporate funds on non-value-enhancing activities.

When arguing in favour of the neutrality rule, Easterbrook and Fischel concentrate on the disciplinary purpose of takeovers, yet it is clear from the discussion in Part 1.5.2. that there are various motives behind takeover activities, and not all of them are value-enhancing. Transactions based on exproprietary motives such as Pfizer's attempted acquisition of AstraZeneca[1457] which was driven mainly by tax-avoidance may diminish not only the shareholders' wealth but also harm the economy as a whole.

Even if one assumes that takeovers typically increase the value of firms post-acquisitions, constant threat of a takeover coming from an active market for corporate control due to the board neutrality rule may result in a non-desirable outcome of managerial myopia.[1458] Excessive pressure put on the board to keep company's share price high often translates to a focus on short-term financial results rather than concentrating on long-term growth. Empirical studies of Nuttall[1459] and Guthrie and Hobbs[1460] both indicate a negative impact of takeover threat on firm's subsequent investment. Hall reports that majority of companies that became targets of acquisitions in takeover-friendly jurisdiction such as the UK had a relatively low R&D spending.[1461] Chemmanur and Tian, on the other hand, present evidence suggesting that anti-takeover provisions have a positive effect on innovation by insulating executives from short-term

[1456] Nuttall, 'An Empirical Analysis of the Effects of the Threat of Takeover on Uk Company Performance' (1999) Nuffield College, University of Oxford, Working Paper 30.
[1457] See fn 610.
[1458] Stein, 'Takeover Threats and Managerial Myopia' (1988) 96 Journal of political economy 61, 63.
[1459] Nuttall (n1456) 30.
[1460] Guthrie and Hobbs, 'Anti-Takeover Defenses and Their Role in Investment' Victoria University of Wellington Working Paper 2017 (reporting the executives to delay investment decisions relative to the situation with no threat of hostile takeover).
[1461] Hall, 'The Effect of Takeover Activity on Corporate Research and Development' in Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (National Bureau of Economic Research, University of Chicago Press 1988) 93.

pressures of equity markets.[1462] Without takeover defences board may suffer from blinkered perspective exposing the firm to the risk of losing sight of its strategic business model, which in turn negatively affects firm-level decisions, especially in the area of R&D, and compromises its long-term competitiveness. [1463] Stout observes that shareholders, who are not a homogenous group, have different investment time horizons which vary from short orientation, where shareholders are concentrated on quick capital gains, to long-term 'buy and hold' strategies.[1464] The board neutrality rule may, therefore, not be in the interest of shareholders as a whole as the long-term oriented shareholders often lose when the firm does not make strategic investments.

Directors in the US do not face the same pressure of short-term share price fluctuations from the capital market as their counterparties in the UK thanks to the board discretion rule. The fact that the board is not obligated to sell the company whenever the shareholders would wish it to do so allows directors to make decisions focusing on the firm's long-term competitiveness what may be beneficial not only for the individual firm but also the economy as a whole.[1465] On the other hand, those who support management entrench theory claim that firms' long-run performance may be compromised by giving directors a discretion to adopt antitakeover measures since they are likely to use them to insulate their position from competition in the market for corporate control.[1466] The board, free of any meaningful market disciplining has reduced incentives for cutting costs and increasing efficiency.[1467] Empirical studies[1468] showed that Delaware's firms in the 1990s were worth more than firms incorporated elsewhere, but the so-called 'Delaware Effect' began to fade away around the mid 1990s. Having assumed the link between corporate law and firm value, it has been explained that value of Delaware's firms was higher when Delaware was still considered to have relatively takeover-friendly laws in comparison to

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[1462] Chemmanur and Tian, 'Do Antitakeover Provisions Spur Corporate Innovation? A Regression Discontinuity Analysis' (2018) 53 Journal of Financial and Quantitative Analysis 1163; *cf* Mahoney, Sundaramurthy and Mahoney, 'The Effects of Corporate Antitakeover Provisions on Long-Term Investment: Empirical Evidence' (1997) 18 Managerial and Decision Economics 349 (which indicated that the average effect of antitakeover provisions on subsequent long-term investment is negative).

[1463] Lipton, 'Takeover Bids...' (n1448) 109.

[1464] Stout, 'The Problem of Corporate Purpose' (2012) 48 Issues in Governance Studies 1, 8-9.

[1465] Lipton, 'Takeover Bids...' (n1448) 110.

[1466] Manne (n52) 113-5.

[1467] Mahoney, Sundaramurthy and Mahoney (n1462).

[1468] Daines, 'Does Delaware Law Improve Firm Value?' (2001) 62 Journal of Financial Economics 525 (providing evidence that companies incorporated in Delaware are worth more than those incorporated elsewhere.); Subramanian, 'The Disappearing Delaware Effect' [2002] Harvard Law School John M Olin Center for Law, Economics and Business Discussion Paper Series 391 (partially confirming Daines's contention, finding a positive effect of 2-3% during the period of 1991-1996, yet for the years 1997 - 2001 there was no positive effect reported).

other states; Delaware's transition towards an anti-takeover regime as a result of solidification of just say no defence in the mid 1990s caused the value-increasing effect to disappear.[1469]

Individual corporate detriments also have an impact on the entire national economy because such systemic behaviour curbs the country's overall level of innovation and limits its global competitiveness.[1470] The consultation carried out in 2011 by the UK concerning 'A Long-term Focus for Corporate Britain' aimed to examine, inter alia, the problem of short-termism and the economic case for takeovers.[1471] The responses received were inconclusive. Respondents generally believed that short-termism exists in the UK but provided little evidence to demonstrate the scale of the consequences for firms and shareholders. Some did not consider short-termism as a problem in itself. Many of the respondents believed that while indeed facing short-term pressures, the boards of the UK's firms tend to take a long-term. Finally, a lack of evidence that an increased long-term approach would lead to better performance of the economy was also pointed out.[1472]

The board neutrality rule is further believed to disincentive firm-specific investments by the employees, who may lose their jobs as a result of post-acquisition restructuring often aimed at cutting costs and reducing the overall firm's employment. This may limit their willingness to invest their human capital in a given company.[1473] Since the infamous Cadbury's takeover, in which the shareholders were not necessarily compromised by the deal (but it is at least possible that the wider constituencies of interested stakeholders were), voices claiming that the interests of shareholders alone may not always be the most worthy of protection have been gradually growing in power. The Green Paper on Corporate Governance Reform published in 2016 sought to stimulate a debate on the possibility of strengthening the employee voice at boardroom level,[1474] which would result in some empowerment also in the takeover context. Despite initial plans for the reform aiming to include the employees' representatives to

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[1469] Subramanian, 'The Disappearing...' (n1468).
[1470] Cosh, Hughes and Singh (n93) 7-8.
[1471] Department for Business, Innovation and Skills, 'A Long-term Focus for Corporate Britain.' Summary of Responses (March 2012) 3 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/207536/11-797-summary-responses-long-term-focus-corporate-britain.pdf> accessed 10 September 2017.
[1472] ibid 6.
[1473] See Part 1.5.2.
[1474] Department for Business, Energy and Industrial Strategy, 'Corporate Governance Reform.' The Government Response to the Green Paper Consultation (August 2017) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/640631/corporate-governance-reform-government-response.pdf> accessed 15 November 2017.

the board,[1475] amid criticisms and concerns regarding the practicality of such a policy,[1476] a more practical reform has been adopted in the form of additional reporting requirements [1477] and flexible method of engagement with the workforce[1478].

Notwithstanding the alleged benefits of takeovers, hostile acquisitions can be very disruptive for the firm and distract directors' attention from the company's ordinary business. [1479] This issue can, however, be addressed by certain substantive and procedural rules of the takeover regime. The UK, which is characterised by an active market for corporate control, limits the scope for disruption and delays in the transaction's completion by institutional framework with the Panel promptly addressing any takeover-related doubts and issues, the strict timetable outlined in the Takeover Code, the 'put up or shut up' rule,[1480] and, in spite of appearances, the board neutrality rule. In the US neither a target company nor an acquirer has to respond, as is the case in the UK pursuant to the PUSU rule, to the gossips or leaks related to a possible takeover. When asked, the boards can simply issue a 'no comment' statement because they are generally under no obligation to disclose any preliminary discussions or intentions to launch the bid, even if requested to confirm rumours by investors, the media or the exchanges.[1481] 'No comment' policy, on the one hand, helps to minimise the disruptive effect of the takeover market. On the other hand, it does nothing to limit uncertainty arising from takeover rumours what may in itself be quite disruptive to the target company.

Thus, whilst in the UK a typical acquisition should take approximately three and a half months to complete as prescribed by the Takeover Code,[1482] in the US it takes about five months for a friendly acquisition, and substantially longer in case of a hostile acquisition mainly due to the target board's ability to use defensive mechanisms.[1483] Since time is a crucial success factor in case of hostile

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[1475] Theresa May MP, Speech to Conservative Party Conference, 4 October 2016 ('So later this year we will publish our plans to have not just consumers represented on company boards, but workers as well.').
[1476] Warrell and Pickard, 'Plans for UK to Put Workers on Company Boards Falters' *Financial Times* (31 October 2016) <https://www.ft.com/content/22128636-9ece-11e6-891e-abe238dee8e2> accessed 16 November 2017.
[1477] CGC, provision 4; The Companies (Miscellaneous Reporting) Regulations 2018, which amended Part 15 of the CA 2006 (requiring large companies to include a statement in their strategic report outlining how the directors have considered the factors set out in section 172(1) of the CA 2006 when performing their duties).
[1478] CGC, provision 5.
[1479] Lipton, 'Takeover Bids...' (n1448) 110-11.; Scherer (n70) 77-81.
[1480] See Part 3.5.6.
[1481] Hazen, 'Rumor Control and Disclosure of Merger Negotiations or Other Control-Related Transactions: Full Disclosure or" No Comment"-the Only Safe Harbors' (1987) 46 Maryland Law Review 954, 961.
[1482] Unless there is a second bidder, then the process would take longer.
[1483] Armour and Skeel Jr (n442) 1746.

acquisitions,[1484] one would expect the US capital markets to be characterised by a low level of unsolicited bids. While the proportion of hostile bids to the total number of M&A announced in the US is indeed lower than in the UK,[1485] it remains higher than in most of other jurisdictions. In comparative terms, the overall number of hostile takeovers adjusted for the size of the economy is slightly higher in the US than in the UK[1486] despite the board discretion rule adopted in the US (which may suggest that the rule does not discourage takeovers).

One must, however, note that companies, depending on the corporate governance rules in a given jurisdiction, may face significant level of risk of disruptive events regardless of the vitality of takeover market and the rule regulating target board's response to the offer. For example, in the UK it is relatively easy to accumulate the stake necessary to call for a general meeting to remove a director by ordinary resolution even in absence of change of control transaction, which may potentially disrupt the company's ordinary business operations. Removal of directors in the US is more difficult because of existence of staggered board and other mechanisms designed to protect incumbent directors.[1487] They can therefore focus both on day-to-day operations as well as long-term investment of the firm with more peace.

The possibility of extensive M&A litigation, which is influenced by, inter alia, substantive rules on board's decision-making, is another factor contributing to the overall disruptiveness of the regime. Yet, according to the report of Wachtell Lipton Rosen & Katz, the prominent US law firm known for representing the corporate directors in takeover battles, high rate of takeover litigation in the US should not be viewed as a sign of trouble because the US court system is quick and efficient - most of the lawsuits are settled within 60 days of filing.[1488] Sometimes, however, it may take months to Delaware courts to address and resolve a case.[1489] The M&A litigation nevertheless remains very expensive, having potential of generating substantial costs for the acquirer, the target company and the target shareholders (depending on the parties involved) especially in cases of high-profile takeover transactions. Apart from their own legal costs, target companies typically pay plaintiffs' lawyers fees, which on average equal to USD1.2 million (per lawsuit), but can also be as high as USD25

[1484] Sidak (n965).
[1485] Armour and Skeel Jr (n442) 1738.
[1486] ibid 1741.
[1487] See part 2.3.1.
[1488] Wachtell and others (n266) 12.
[1489] Armour and Skeel Jr (n442) 1745.

millions as was the case in Del Monte Foods buyout.[1490] Due to the composition of the Panel and the way it performs its duties, lawyers in the UK are generally not as heavily involved in M&A deals,[1491] which translates to reduced cost of such transactions. Thus, the UK's system of Panel's enforcement and informal consultations, where takeovers are very rarely litigated, appears to be both more time- and cost-effective than the US one.

Coates[1492] raises an interesting point that in the US, the view on legality of takeover defences is noticeably split between scholars and practitioners – the academic community being usually against defensive tactics, and practitioners being mostly the advocates of takeover defences. Such division is not surprising given the characteristics of the Delaware takeover regime. Frequently challenged boards' decisions translate into the profit for the law firms and financial advisors. Since takeovers are more often litigated in jurisdictions that allow defensive measures rather than in those with strict prohibition, financial interests of the lawyers and the M&A industry in general may be among the most prevalent motives for advocating in favour of board discretion rule by the US practitioners.

Finally, it is worth stressing that although both Easterbrook and Fischel are strong advocates of the view that regulatory competition[1493] usually generates laws increasing shareholders' value, they accept that takeover regime insulating directors against takeovers represents one instance in which state competition has failed because it created suboptimal rules.[1494] Almost all of the firms going public select either their home state or Delaware to incorporate[1495] and nearly 95% of all companies seeking legal rules outside their home jurisdiction end up in Delaware.[1496] Similarly, the large number of companies that reincorporate choose to do so in Delaware. Yet, a very influential empirical study conducted by Daines found very little support for the thesis that takeover rules affect firms' incorporation choices.[1497] The popularity of Delaware is thus often explained not through the superiority of its takeover regime but rather through 'network quality' or 'network effect' which claims that firms simply prefer to incorporate

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[1490] Daines and Koumrian, 'Merger Lawsuits Yield High Costs and Questionable *Benefits' DealBook NY Times* (08 June 2012) <https://dealbook.nytimes.com/2012/06/08/merger-lawsuits-yield-high-costs-and-questionable-benefits/> accessed 19 August 2016.
[1491] Lawyers play less of a role in the context of hostile takeovers, but in relation to friendly takeovers they are still heavily involved from the outset.
[1492] Coates, 'Empirical Evidence on Structural Takeover Defenses: Where Do We Stand?' (2000) 54 University of Miami Law Review 783.
[1493] See pages 197 -198 for more detailed discussion on state competition in the US.
[1494] Bebchuk and Ferrell (n1400) 1198.
[1495] At least those made at initial public offering (IPO) stage. See Daines, 'The Incorporation…' (n1399).
[1496] ibid 1572-3.
[1497] Daines, 'The Incorporation…' (n1399) 1591.

in a state with the highest number of firms overall incorporated in a given state.[1498] Another explanations provided are: familiarity of both investors and legal advisors with the law of Delaware,[1499] and a great number of highly skilled and specialised judges and legal practitioners[1500]. An alternative theory, 'race to stability and predictability' developed by Romano[1501] assumes that companies seek predictability and legal certainty. Delaware is therefore the main choice as a state of both incorporation and reincorporation for American firms due to its well-developed case law creating predictable legal outcomes which facilitate planning and reducing costs. It can, indeed, be argued that Delaware's law may provide predictability and stability, but it does not mean that the substantive content of its regulations governing directors' conduct is value-maximising. Not only available theoretical discussion, but even empirical evidence regarding the motives behind and the effects of state competition for corporate charters do not provide any conclusive observations. Many of the event studies measuring the stock reactions to the change of the state of incorporation showed either no or insignificant change. Daines's study[1502] indicated an increase in share price after the firms reincorporated in Delaware, however the factors other than the change of the state of incorporation could possibly explain the gains recorded. The most recent study by Anderson and Manns covering the years 2001 - 2011 implies that the law governing corporate affairs in Delaware neither adds nor subtracts value relative to that of other states,[1503] which oddly suggests that the applicable law simply does not seem to matter to capital markets.

[1498] ibid 1596; Romano, 'Law As…' (n1399); Bebchuk and Cohen (n1400).
[1499] Romano, 'Law as…' (n1399) 273-5.
[1500] ibid 277 and 280.
[1501] ibid 280-1.
[1502] Daines, 'Does Delaware...' (n1468).
[1503] Anderson and Manns, 'The Delaware Delusion' (2015) 93 North Carolina Law Review 1049.

CHAPTER VII Reform Recommendations for China

Perhaps the first step to designing law reform recommendations is to consider the objectives that particular regulations seek to achieve, and to take a realistic view of what the reform can accomplish given the existing circumstances. Recognition of the technical drafting difficulties, as well as the complicated interactions among political, social and economic factors, is key in this context. When proposing reform it is thus crucially important to account for the country's existing legal and institutional framework as well as its political and socio-economic environment, because reform's ultimate acceptance and effectiveness will depend on local factors which are beyond the drafter's control.[1504] A critical evaluation should be conducted by reflecting on which solution would be 'best adapted to its purpose and operate most justly' in a selected jurisdiction.[1505] The main criteria of developing reform of the takeover regulations adopted in this thesis, is suitability of the proposed regime for the objectives set by China's regulators, its compatibility with the existing laws and regulations and ensuring protection of all parties involved, especially minority shareholders.

Proposals reforming written law will remain ineffective unless they can be successfully implemented in a selected jurisdiction. For this to occur, reform recommendations must be consistent with the country's existing policy.[1506] Margaret Woo[1507] notes that in China's top-down society any reform proposals indirectly challenging national goals and identity are doomed to fail. Since both the political and legislative agenda in China is largely determined by the CPC,[1508] recommendations would have to be acceptable to the Party and the drafting process should begin by considering whether the proposed law creates a feasible regime implementable in the local context. It should then proceed by reflecting on the phase when the law actually comes into effect, and recommendations must therefore also focus on training for judges and government officials responsible for enforcing the law.[1509]

[1504] Simon, 'Legal Reforms for Civil Society – a Reflection After Ten Years' *Alliance Magazine* (01 March 2000) <https://www.alliancemagazine.org/analysis/legal-reforms-for-civil-society-a-reflection-after-ten-years/> accessed 10 August 2018.
[1505] Zweigert and Kötz, *An Introduction to Comparative Law 2* (Oxford University Press 1987) (as cited in Hill, 'Comparative Law, Law Reform and Legal Theory' (1989) 9 Oxford Journal of Legal Studies 101).
[1506] Commonwealth Secretariat, *Changing the Law: A Practical Guide to Law Reform* (Commonwealth Secretariat 2017).
[1507] Woo, 'Court Reform with Chinese Characteristics' (2017) 27 Washington International Law Journal 241, 242.
[1508] *Changing the Law* (n1506)
[1509] Simon (n1504).

The objective of this Chapter is therefore to put forward reform recommendations aiming to reach attainable goals and providing workable, rather than ideal solutions, which can be implemented in China. Embedded in a complex legal, political and socio-economic context, proposed changes attempt to reform regulation of directors' conduct in hostile takeovers in line with China's existing policies on regulation of takeover activities and goals that the regulation is set to achieve.

As mentioned in Part 1.1, many of China's listed companies perform poorly financially. The problem of insiders' control manifested through the lack of accountability of executive directors and expropriation of corporate property by the controlling shareholder(s) is central to this issue. Strengthening and improving the management of China's listed companies, protection of the lawful rights and interests of companies and their investors, the effective functioning of capital markets, promotion of the optimal allocation of market resources and acceleration of economic development through restructuring industries are among the original primary objectives behind the adoption of China's takeover regime,[1510] all of which, if attained, would ultimately improve the performance of listed firms. The goals that China is pursuing almost two decades later do not vary significantly from those original objectives. Improving corporate performance was listed in China's 13th Five Year Plan (2016-2021)[1511] as one of the major objectives for the near future, followed by attracting foreign and domestic private capital. The development of open, transparent and healthy capital markets is also high on China's agenda for the coming years, so has the optimal market-based allocation of domestic and international resources.[1512]

China therefore needs laws and regulations that will develop strong corporate and market governance and - as a result - better corporate performance and economic growth. The establishment of an efficient takeover market may potentially constitute an element helping to achieve these goals. The authorities' efforts to improve China's takeover regulations should, in theory, assist in their achievement. Despite a modern and fairly comprehensive takeover framework and its gradual liberalisation from government intervention, the Chinese regime is still characterised by a significant degree of uncertainty and unpredictability regarding both the process and the outcome of a takeover bid. Among the most acute areas of concern of the existing takeover regime which are responsible for

[1510] See Part 5.2.
[1511] Zhonghua Renmin Gongheguo Guomin Jingji He Shehui Fazhan Di Shisan Ge Wu Nian Guihua Gangyao [The 13th Five-Year Plan for Economic and Social Development of the People's Republic of China (2016-2021)] adopted by the State Council, 17 March 2016.
[1512] ibid

the fact that China has not yet experienced a more active market for corporate control, despite its capital markets evolving towards more private and widely held companies are: the possibility of state intervention,[1513] inconsistent enforcement of the laws and regulations governing takeovers by the CRSC,[1514] weak protection of minority shareholders,[1515] and the ambiguity as to the required conduct of the target board of directors.

Regulation of target directors' role and their authority to use defensive measures is particularly relevant in the context of hostile takeovers and for the efficient operation of the market for corporate control. Reforming directors' duties may help to address, at least partially, other concerns, such as insufficient protection of minority shareholders and weak enforcement of the takeover regime. Apart from having a direct effect on the final outcome of the actual offer, uncertainty and limited predictability create significant obstacles for the development of an active takeover market in China. Based on the analysis in Chapter 4, China's takeover regime appears to be a legal transplant with a mixture of the US and the UK-modelled provisions partially adapted to local circumstances with no bright-line rule of either prohibiting or allowing the use of anti-takeover measures. Despite many calls for reform,[1516] no revision of provisions regulating the target board's conduct has been carried out since 2006. Lack of clarity and ambiguity of Article 8 and Article 33 of the Takeover Measures create uncertainty. Bidders for Chinese listed firms bear substantial risk in relation to the probability of the success of takeover attempt. The prospect of delay or the possibility of the bid's frustration by the target board may have a significant deterrent effect on potential acquirers in China because it is possible that resources invested in preparing and conducting the bid will be wasted. Since complying with the procedural requirements outlined in the Takeover Measures[1517] is both expensive and time-consuming, transparency, procedural certainty and predictability as to the likelihood of the deal being completed, as well as confidence in the time-frame of the transaction are of crucial importance for potential acquirers. Lack thereof has been hampering development of more active Chinese market for corporate control and seems to be one of the reasons why, although permitted by law, hostile takeovers remain a rare phenomenon in China.

[1513] See pages 102 and 132- 134.
[1514] See pages 148 and 240.
[1515] See pages 136-138.
[1516] See eg Huang, 'The New...' (n825) ; Cai, 'Hostile Takeovers...' (n10); Chen (n17).
[1517] See Part 5.6.

7.1.General Approaches to Reform of China's Takeover Regulations

Based on the analysis conducted, there appears to be four broad recommendations for the reform of the Chinese regulation of directors' conduct within the takeover regime. The first option would be to adopt the US-style board discretion rule. The second would implement a strict UK-style board neutrality rule. One or other are usually advanced by scholars researching takeover regulation in China.[1518] The third involves adoption of an alternative arrangement significantly amending the existing regime. Lastly, a recommendation may propose no fundamental change to the substantive law regulating directors' conduct. The general provisions of the existing regime regulating directors' role in a hostile takeover context would remain similar, without a strict and direct adoption of any of the models analysed, whereas procedural aspects (such as improvement of the board's independence in decision making) and specific matters concerning the regulation of the target board's conduct could be reformed in a piecemeal fashion to minimise legal ambiguity and to address the main areas of concern of the existing regime.

The first argument why neither the US nor the UK rules should be adopted wholesale in China relates to the reason why neither was adopted in the first place. Despite claims regarding chaos theory and random transplant of takeover regulations in China in 1990s/2000s,[1519] it is plausible that the CSRC deliberately did not directly transplant either rule because it believed neither to be wholly suitable. Concerns regarding China's legal and institutional system remain as valid now as they were almost 30 years ago when the development of a takeover regime began, despite many positive reforms and developments. Various amendments have been introduced to the Takeover Measures since their enactment in 2002, including amendments to Article 8 and Article 33 which directly regulate the board's conduct and the use of takeover defences, yet a clear and unambiguous position with regard to these matters has never been established by the regulator.

The UK's strict neutrality rule is often favoured over the board discretion rule because of its supposed monitoring and disciplining role, which is believed to enhance the financial performance of listed companies. Although improvement in the performance of listed firms has been cited as one of the main objectives of takeover regulations in China, adoption of a non-frustration approach may not

[1518] See, eg Cai, 'Hostile Takeovers...' (n10) (proposing a prohibition of post-bid defences unless approved by the 2/3rd of shareholders); Chen (n17) (recommending expanding the board neutrality rule in China) ; Wang (n28); Varottil and Wan (n21) (proposing adopting strict board neutrality rule).
[1519] See pages 198-199.

achieve the desired result because of the differences in the underlying agency problems faced by companies in those jurisdictions. Whilst in the UK and the US the major problems arise between directors and shareholders, Chinese firms are more troubled by the risk of opportunism of controlling shareholders vis-à-vis minority shareholders.[1520] Thus, whilst an alleged overall monitoring and disciplining effect in relation to the market for corporate control may generally be desirable for companies in China, it predominantly addresses type I agency problems and does not tackle the conflict between controlling and minority shareholders, which is more prevalent in China. Further, due to the concentrated ownership of Chinese firms, even the disciplining effect and its alleged positive impact on type I agency problems, which also exist in China, may be substantially limited. Executive directors are not likely to respond similarly to the threat of an unsolicited change of control transaction in China as they do in the UK: such a threat in China would be insignificant as, in the majority of cases, whether or not the hostile bid succeeds would be determined by the firm's controlling shareholder. As long as the controller is satisfied with the existing board, directors need not be overly concerned about the takeover market's monitoring function, unless the bidder offers the premium higher than the extracted private benefits of the controlling shareholder. Finally, one must not forget that beneficial nature of hostile takeovers in fighting type I agency problems has not been authoritatively proven as shown in Part 1.5.2.[1521]

It should also be noted that it is unlikely that changes necessary to improve corporate performance in China could be realised solely through reform focused on two provisions of the takeover regime regulating the target board's conduct. This objective can perhaps be better achieved through improvement and enhanced enforcement of the existing corporate regime, which would itself fulfil a disciplining function. Although beyond the scope of this thesis, the importance of reforming stock markets and managerial markets, as well as strengthening competition law in order to improve the performance of listed companies is also worth noting. Therefore, not too much emphasis should be placed on the market for corporate control as a disciplining mechanism that is supposed to miraculously heal Chinese corporations and improve their financial profitability.

In terms of the other objectives of takeover regulations envisioned by China's regulators, namely economic growth and better allocation of resources, the UK's board neutrality rule is assumed to provide means to those ends because it makes

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[1520] See pages 152-156.
[1521] See Part 1.5.2 on discussion of empirical evidence on the effectiveness of monitoring and disciplining effect of the market for corporate control.

it more difficult for directors to resist value-enhancing bids. However, as noted above, controlling shareholders, prevalent in Chinese listed firms, can easily oppose value-enhancing offers if they were to end rent-seeking.

The adopted rule regulating the board's conduct should be consistent with the jurisdiction's legal framework, especially the orientation of its corporate regime. Pursuant to China's Company Law, it is the shareholders' meeting, rather than the board, which is central to decision-making. The non-frustration rule in the UK constitutes part of a larger shareholder empowerment scheme which, through enhanced voting and exit rights, limits the discretion of the board. As such, no major obstacle should be encountered by China's corporate law regime if adopting the UK's strict approach. However, Ventoruzzo[1522] notes that implementation of the approach empowering shareholders in jurisdictions with concentrated ownership structures may be counterproductive. Giving shareholders a decisive role, both in general corporate governance and the takeover context specifically, risks majority oppression of minority shareholders,[1523] especially in a jurisdiction like China where no adequate and effective system of checks and balances against controlling shareholders exists. If the strict board neutrality rule was to be adopted in China without strengthening the enforcement of other takeover rules, especially in regard to mandatory bids, minority shareholders could find themselves in a firm controlled by a single shareholder which abuses its position to loot a newly acquired company.

As a corollary, where the controlling shareholder opposes the takeover, it prevents it even in the absence of a majority holding by approving takeover defences employed by the board. China's minority shareholders are susceptible to a collective action problem and rational apathy, and rarely participate in general meetings,[1524] making them unlikely to be able to oppose the resolution. Moreover, the UK's neutrality rule implemented in China is likely to reduce directors' accountability to minority shareholders by providing dominant shareholders with the option of 'whitewashing' the use of board defences, significantly limiting the minority's chances of challenging deployment of such measures in court.

[1522] Ventoruzzo (n1138).
[1523] Stout, 'Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right' (2005) UCLA School of Law, Law-Econ Research Paper No 05-21, 19.
[1524] See page 155.

Furthermore, it may appear that strict board neutrality rule would not be suitable for China due to its alleged promotion of managerial short-termism,[1525] diminishing firms' long-term focus and reducing R&D investment, which compromises the long-term competitiveness of firms incorporated in jurisdictions adopting the rule. The focus of China's policy is on growing national champions[1526] and innovative firms capable of competing in the global markets. Thus, since China's listed firms need capital, it appears desirable for executives to focus on share prices in order to attract and retain investors, given that the state, as a major shareholder, might willingly compromise short-term gains in favour of long-term competitiveness of China's national brands. Executives with a shorter-term horizon could therefore act to balance the interests of private investors and the state.

Lastly, many of the alleged benefits of the board neutrality rule are based on the assumption of the efficiency of both capital markets and the market for corporate control.[1527] The former is believed to accurately price shares, which then represent the value of the company; the latter is expected to identify inefficiently managed firms and enhance their value by monitoring and disciplining their boards.[1528] While the UK is generally considered to have fairly efficient capital markets,[1529] China still faces challenges in this respect. Prices of shares listed on Chinese exchanges are greatly driven by government interventions, frequent dealings by better informed insiders[1530] and scandals involving market manipulation.[1531] A number of studies[1532] reports widespread financial statements' fraud in China caused by a lack of professional ethics of boards of listed companies and accounting firms, as well as weak legal enforcement. Share prices in China may not, therefore, accurately reflect the underlying value of the listed companies, which is indispensable for the effective functioning of

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[1525] See page 207.
[1526] Weinreich-Zhao (n819) 64.
[1527] See page 15.
[1528] See Part 1.5.2.
[1529] See eg Konak and Şeker, 'The Efficiency of Developed Markets: Empirical Evidence from Ftse 100' (2014) 2 Journal of Advanced Management Science.
[1530] Insider trading is sometimes believed to actually improve the efficiency of the market. See Beny, 'Insider Trading Laws and Stock Markets around the World: An Empirical Contribution to the Theoretical Law and Economics Debate' (2007) 32 Journal of Corporation Law 237.
[1531] See eg Xu, 'Performance of Securities Investment Funds in China' (2005) 41 Emerging Markets Finance and Trade 28, 27-42; Laurence, Cai and Qian, 'Weak-Form Efficiency and Causality Tests in Chinese Stock Markets' (1997) 1 Multinational Finance Journal 291; Wei, 'Maximising the External Governance Function of the Securities Market: A Chinese Experience' International Company and Commercial Law Review, No 3, 2008.
[1532] Bai, Yen and Yang, 'False Financial Statements: Characteristics of China's Listed Companies and Cart Detecting Approach' (2008) 7 International journal of information technology & decision making 339; Wei, Chen and Wirth, 'Detecting Fraud in Chinese Listed Company Balance Sheets' (2017) 29 Pacific Accounting Review 356; Pei, 'The Financial False and Its Countermeasures in Chinese Listed Companies' (2005) 3 Journal of Changzhou Institute of Technology.

takeover market. A major argument in favour of strict board neutrality is its favourable impact on the market for corporate control, which is believed to be able to identify underperforming targets based on share prices. If there is no reliable base for such identification in China, the importance of the value-increasing effect of active market for corporate control may be of less significance. Indeed, Wachter suggests that the more inefficient the markets, the more support the board discretion rule gets.[1533] It is aligned with the argument made by Stout that in the case of a doubtfully efficient stock market, as is the situation in China, the adoption of regulations allowing takeover defences may be a better solution since the board of directors is inevitably better informed than shareholders about the company's current value and its future prospects.[1534] If the board believes that the hostile bid is inadequate (i.e. it does not reflect the company's fundamental value) even when it offers a substantial premium over the pre-bid market price, it is in the interest of shareholders for such a takeover to be stopped.[1535]

A hostile acquisition is a classic example of a conflicted transaction in which one or more directors may appear on both sides of the transaction or have a personal interest, such as maintaining the office. The UK Takeover Code approaches this potential conflict by removing directors from the transaction equation, limiting the opportunities for self-serving decisions taken in relation to a specific bid. Adopting a board neutrality rule would, however, also deprive the target board of a full-scale role in protecting shareholders from value-destroying, coercive bids or self-interested conduct by controlling shareholders. In the UK, where shareholders are generally more sophisticated, organised and better informed, and where minority interests are effectively protected by the procedural rules of the Takeover Code enforced by the Panel, such role may appear redundant. In China, however, depriving retail investors of the board's protection, could potentially be harmful, particularly in those companies that have effective corporate governance arrangements where the board is relatively independent from dominant shareholders and genuinely acts in the best interest of the company and all of its shareholders. A complete removal of the board's decisive power would risk facilitating the expropriation of minority shareholders. On this occasion one must note, that some critics of the board

[1533] Wachter, 'Takeover Defense When Financial Markets Are (Only) Relatively Efficient' (2003) 151 University of Pennsylvania Law Review 787, 810-1.
[1534] Stout, 'Takeovers In...' (n1523).
[1535] See pages 47- 48 on discussion of the concept of 'substantive coercion' in the US.

discretion rule adopted by Delaware[1536] may not necessarily see it as inherently wrong, but rather as inappropriate for the *existing* US corporate landscape because the shareholder structure and the characteristics of investors have changed significantly since the adoption of the *Unocal* standard. Whilst in 1980 retail investors held 72% of firms' equity, in 2009 this number dropped to 27%.[1537] It is thus argued that whilst a board discretion rule in which directors' defensives tactics must be proportionate to the threat identified may indeed protect retail shareholders, such protection is unnecessary when the majority of shares are owned by institutional investors which often hold block of shares and have adequate resources and incentives to engage in corporate affairs. Thus, the standard established by Delaware Court's landmark decision at a time when most shareholders characterised as atomised, ill-informed and suffering from rational apathy and collective action problem, may no longer be appropriate in the US. Shareholders of Chinese listed firms, however, except the state as a controlling shareholder, share many similarities with US shareholders from the *Unocal* era.[1538] The protection afforded by the US-style board discretion rule might therefore be beneficial for all shareholders of the target company, but only if the board is fully independent, which at the moment is highly unlikely in China as corporate boards are often dominated by the controlling shareholder.

A strict transplant of either of the US or UK approaches requires specific legal and institutional infrastructures that China does not presently possess. This is especially apparent in case of the US's court-centred approach where directorial discretion in relation to defences is subject to judicial scrutiny aimed at preventing misuse of anti-takeover mechanisms. The board discretion rule requires an efficient court system and a legal system facilitating litigation. Due to the complexity of the cases handled and the fact that the key actors on the US takeover scene are lawyers and judges, a large and specialised legal workforce appears to be necessary for its efficient functioning.

Analysis suggests that the Chinese legal system generally does not facilitate litigation[1539] and that China's court system lacks the necessary efficiency.[1540] Unlike in the US, China lacks qualified judges with sufficient expertise in

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[1536] Eg Gilson and Gordon (n1140); Gurrea-Martínez, 'New Agency Problems, New Legal Rules: Rethinking Takeover Regulation in the Us and Europe' (2017) 3 Ibero-American Institute for Law and Finance, Working Paper Series 2016.
[1537] Gilson and Gordon (n1140) 874.
[1538] For the description of the characteristics of shareholders of China's listed firms see pages 155 and 192.
[1539] See Part 5.7.2.
[1540] It often takes months to the courts to address the case. Lin, 'Derivative Actions in China: Case Analysis' (DPhil thesis, University of Ediburgh 2014).

corporate and securities matters to determine the complicated issues of directorial breaches of duty in the complex takeover setting. Judicial training in China is still in its infancy and significant amounts of time and resources may be needed before training of an adequate number of judges competent to deal with such issues is completed.[1541] In addition, the selective attitude of Chinese courts in deciding which directors' duties cases to accept[1542] indicates their unwillingness to deal with complex or 'sensitive' cases because China's judiciary is not entirely independent from the state and political influence. Therefore, if directors breach their fiduciary duties while responding to a takeover offer, the effective protection of shareholders' rights and the interests of the company cannot be guaranteed, especially if they, as defendants in a lawsuit, have connections with the government. Indeed, lack of adequate courts and legal infrastructure has been listed as one of the reasons why the CSRC might have opted *not to* fully adopt the board discretion rule.[1543] Despite efforts towards judicial reform since the enactment of the Takeover Measures,[1544] it seems unlikely that the Chinese courts are equipped to deal with the US-like takeover regime. The recent establishment of the new Financial Court in Shanghai[1545] may be able to address this issue, although it remains unclear whether cases involving corporate disputes within listed companies fall under the jurisdiction of the court and the efficiency of the court has not yet been fully tested in practice. It would therefore be premature to propose adoption of a model which depends heavily on an effective and fair judicial system.

A related difficulty of the adoption of the board discretion rule in China is its reliance on the concept of fiduciary duties. Based on the civil law tradition, China's legal system may not be able to effectively constrain the kind of board misconduct which is likely to occur in a conflicted transaction such as a hostile takeover. Firstly, the fiduciary principle in China, similarly to the rest of its corporate regime, is considered formal rather than functional.[1546] The existing regime lacks comprehensiveness and leaves regulatory gaps, perhaps even reveals deficiencies in regulatory capacity. Opting for a US-style board discretion rule would therefore require development of detailed rules governing the fiduciary principle, but to specify fiduciary duties in a detailed statute carries the risk of under-coverage, given that that the variety of factual circumstances

[1541] Tricker (n858) 21.
[1542] See page 146.
[1543] See page 201.
[1544] See page 97.
[1545] See page 149.
[1546] See pages 194-196 on general discussion of formal rather than functional convergence of central elements of the UK, the US and China's corporate regimes.

to which they may apply can neither be easily categorised nor foreseen due to the 'incompleteness of law'[1547] as noted by Pistor and Xu.[1548]

Kanda and Milhaupt further stress the necessity of 'fitness' between the fiduciary duties standard[1549] and the legal infrastructure of a country if the transplant of fiduciary duties is to be deemed successful, that is, used in the same way as in the host country, subject to adaptation to local conditions.[1550] At a minimum, a transplanting jurisdiction should have a viable derivative suit procedure and appropriate incentives for claimants to bring such suits, judges and lawyers that are familiar and comfortable with the use of broad legal standards and courts capable of determining remedies in the absence of explicit statutory guidance.[1551] In China there is lack of substantive implementation and effective enforcement of the law on the books in the area of fiduciary duties which has largely been attributed to limited judicial independence as well as inadequate quality and competence of Chinese courts.[1552] Since China's legal infrastructure does not yet meet Kanda and Milhaupt's standards,[1553] the effectiveness of the board discretion rule which relies on an understanding and enforcement of fiduciary duties, cannot be assumed to be as high as in the US. In China it would thus involve substantial risk of abuse on the part of directors (often under the influence of controlling shareholders) due to the lack of adequate judicial review of their conduct.

Taking all of the above into account, it may be concluded that neither the UK nor the US rules regulating directors' conduct in the takeover context are wholly suitable for China. Similarly, also in general terms, regardless of China's legal, political and socio-economic context, both rules have their own strengths and weaknesses.[1554] Both theoretical and empirical studies as to which takeover

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[1547] A theory of incompleteness of law assumes that law is incomplete if enacted today it cannot unambiguously stipulate for all future contingencies. Incomplete law attempts to specify comprehensively actions that shall be covered but fails to include some which could result in similar harmful outcome. It often uses open-ended, vague wording, as a result of which the boundaries of the law are not clearly delineated.

[1548] Pistor and Xu, 'Fiduciary Duties in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Theory' in Milhaupt (ed), *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* (Columbia University Press 2003).

[1549] Fiduciary duties of directors constitute a 'standard' meaning a 'legal provision that is only given content *ex-post* by an adjudicator who determines both the bounds of permissible conduct and factual issues related to the dispute'. Kanda and Milhaupt, 'Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law' (2003) 51 The American Journal of Comparative Law 887, 895.

[1550] ibid 895.

[1551] ibid 897.

[1552] Howson, 'The Doctrine...' (n1377).

[1553] See eg Chen (n17) 167; Yu, *Comparative Corporate Governance in China: Political Economy and Legal Infrastructure* (Routledge 2007); Pistor and Xu, 'Addressing Deterrence and Regulatory Failure in Emerging Stock Markets Lessons from China' [2004] American Law and Economics Association Annual Meetings, Paper 77; Huang, 'China's Takeover...' (n820) 185.

[1554] For detailed discussion of the strengths and weaknesses of each regime see Part 6.9.

model is associated with more beneficial effects in the short- and long-term remain inconclusive. It is partially linked to the fact that, even if one assumes that takeovers are value enhancing in the aggregate, the efficiency of individual takeovers and individual firms' exposure thereto depends on a variety of factors.

An interesting alternative system of takeover regulation giving shareholders the right to vote on *ex-ante* general approval and *ex-post* rejection of the use of takeover defences by the board was proposed by Gurrea-Martinez in 2016 as the most optimal solution for a jurisdiction with relatively concentrated ownership and sophisticated shareholders.[1555] A very similar approach was proposed by Hui Huang even earlier, in 2006, to reform China's takeover regime.[1556] The proposal envisioned a system with *ex-ante* availability of certain defensive measures which the board could obtain through shareholders' approval at the AGM and an *ex-post* shareholder veto should they not approve the specific use of an anti-takeover tactic. Such a system offers shareholders protection by giving them a periodic right to review their decision to grant the board permission to use anti-takeover measures while, at the same time, preserving the board's flexibility to efficiently respond to takeovers. Yet, since Hui Huang's reform includes *ex-post* shareholder voting, the collective action problem and rational apathy of Chinese minority shareholders would still exist and could also hamper the effectiveness of the system proposed. Consequently, minority shareholders could be denied the chance to exit the company by selling their shares since the decision of the general meeting is binding on company. Further, shareholders in firms with more dispersed ownership would risk not being able to effectively veto unwanted defensive measures, given e.g. the possibility that directors might delay convening the shareholders meeting. Lastly, the problems associated with concentrated ownership will still be present under such regime as the controlling shareholder could easily choose a solution which predominantly favours its own interests at the expense of other investors. Hui Huang suggests that a public enforcement by the M&A Review Committee composed of experts established on the basis of Article 10 of the Takeover Measures[1557] could solve this problem.[1558] This is, however, problematic as the special committee is not an independent body and is not entitled to make a final decision hence its role is only advisory. Moreover, the effective protection of shareholders would further

[1555] Gurrea-Martínez (n1536).
[1556] Huang, 'China's Takeover...' (n820) 193-4.
[1557] See page 102 for detailed description and membership of the M&A Review Committee.
[1558] Huang, 'China's Takeover...' (n820) 189-90.

be hampered by the fact that since 2014 there is no requirement to obtain an *ex-ante* approval of takeover transactions from the CSRC.[1559]

The last and preferred proposal involves no fundamental change with respect to the board's position within a takeover context but comprises a piecemeal reform to deal with specific issues within corporate, securities and takeover laws affecting the board's conduct. Whilst only a minor reform of substantive law governing the board's conduct in takeovers will be recommended, a greater attention will be given to strengthening the procedural matters related to takeovers and, more generally, corporate governance of Chinese companies. There are two main reasons why such approach is preferred.

Firstly, to work effectively, adopting any of the three systems discussed above would require a wholesale rethinking and systemic review of laws governing board's conduct which may face resistance from parties benefiting from the existing regime, in particular, the state as controlling shareholder. One-at-a-time amendments may solve the problem of resistance that more comprehensive and fundamental reform is likely to attract.[1560] Moreover, China's regulators attach great importance to regulatory flexibility which often leads to reforms being initially limited in scope (as to territory or extent of changes implemented) and only ramped up to national scale or full-scale reform if they prove to be successful.[1561] The proposed piecemeal approach accords with China's model of law reform by moving incrementally, guided by evaluations of effects. Instead of embarking on full implementation of one of the analysed systems, discrete steps could be taken, their effects observed, and a judgment made as to further action. It is, of course, possible that this approach might not sufficiently address existing problems especially if proposed individual amendments to the regime lacked coordination.

Secondly, such a fundamental and systemic review of the substantive rule governing decision-making powers in takeovers does not seem to be indispensable, at least at this point in time, since the conducted analysis leans towards the conclusion that the regulation of target board's conduct in hostile takeovers in practice may only have a limited effect in China. Concentrated shareholders structure, identity of the main controller, extensive state ownership (which all render the hostile acquisitions unlikely), shareholder-centric company law and corporate governance, problem with enforcing the existing laws and the

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[1559] See page 138.
[1560] Gullifer, 'Piecemeal Reform: Is It the Answer?' in Dahan (ed), *Research Handbook on Secured Financing in Commercial Transactions* (Edward Elgar Publishing 2015).
[1561] See page 96.

socio-political reality of China's corporate landscape all seem to support this observation. Extensive control rights given to the general meeting combined with highly concentrated corporate ownership of Chinese listed firms render many of anti-takeover measures toothless. Moreover, as long as any group, whether the board, the dominant shareholder or the state can unilaterally impact unsolicited takeover bids, it is almost irrelevant, one may say trivial, which substantive approach is adopted in terms of decision-making powers in takeovers. What should particularly be highlighted here is the extent of the Chinese state's role in the capital markets, where the state (at local, provincial and national level) can use both direct (as a controlling shareholder) and indirect influence to impact the outcome of many, if not all, transactions as demonstrated e.g. by the analysis of merger control or a recent case of Vanke and Baoneng. During the infamous takeover battle, Vanke's board run out of options to legally defend the company and the result of the battle seemed to be a forgone conclusion, especially given extensive control rights of shareholders and Baoneng's 25% equity in Vanke. Then out of the sudden the unwelcomed acquirer backed away. The most likely reason for this unexpected turn of events was a pressure exerted by the state which successfully allowed Vanke's board to retain control.[1562] It effectively shows that the state can step in and use an informal veto over a takeover whenever considered necessary or whenever it serves the state's own interest. It may, therefore, be possible that the reason why the board's conduct in the context of hostile takeovers has not been clarified to date, despite numerous calls for reform, is a desire of China's regulators to retain some control over takeover transactions. The state may generally desire an active takeover market[1563] but with the possibility of influencing the outcome of the bid on a case-by-case basis. 'Saving' Vanke from a hostile suitor might have been considered important by the state since it was a well-known and respected firm, a national champion, whose CEO was known to have strong political connections. All the above factors combined make the actual substantive effect of the rule governing takeover defences rather marginal.

As such, it seems that the Takeover Measure's approach to defensive actions, regardless of whether it is a strict non-frustration rule or a board discretion rule,

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[1562] For a more detailed account of the Vanke v Baoneng battle see Kruszewska, 'Target Board's…' (n931).

[1563] Based on China's policy objectives (see pages 104 and 215) it appears that China's regulators prefer a regime which helps to facilitate corporate takeovers, on the other hand, when the market for corporate control finally began to be more active, Liu Shiyu, the then CSRC's chairman, called hostile suitors 'barbarians', 'evil monsters' and 'poisonous demons' in reaction to the infamous Vanke v Baoneng takeover battle. Around the same time, Xiang Junbo, the then CIRC's chairman, compared insurance companies that attempt to hostilely acquire listed firms to 'financial crocodiles. See Kruszewska, 'Target Board's…' (n931).

is likely to be trivial in practice – that is, it makes almost no difference because there is a functional (state-provided) takeover defence equivalent available to target boards with connections, influence and party relationships. Thus, it can be argued that Article 8 and Article 33 of Takeover Measures amount to regulatory window dressing. Rather than being a part of an effective regulatory regime, whose function is to regulate target board's conduct in hostile takeovers, the provisions are empty notions meant to create the appearance of a modern and effectively regulated capital market. This argument is further supported by the analysis of historical development of China's takeover system, which shown that its first takeover regulation - the Issuing and Trading Shares Provisions from 1993 and then the Takeover Measures from 2002 were adopted to a great extent to attract much-needed capital from Hong Kong. Further reforms of the takeover regime also largely served to increase the confidence of both foreign and private domestic investors.

As a result, it seems that hostile takeovers and regulation of the target board's conduct are unlikely to make a significant difference in addressing weak performance of Chinese companies through the disciplining role of takeovers. Yet, although it cannot be expected that market for corporate control will play any significant role in disciplining company's directors, the M&A activities may still help to accelerate economic growth through firms' restructuring and better allocation of resources, which does not necessarily require occurrence of hostile takeovers. Enhancing transparency of the transactions occurring on the takeover market would also increase investors' confidence in committing their capital to China, which is among the country's top priorities.[1564] Therefore, China should still attempt to stimulate takeover activities by creating a level-playing field for targets and acquirers and by protecting the rights and interests of shareholders in M&A transactions. Therefore, although a full-scale reform of Articles 8 and Articles 33 of the Takeover Measures is not indispensable at this time given the triviality of the rule governing decision-making in hostile takeovers, China could nonetheless benefit from clarifying certain issues related to these provisions since some board's participation is required under the existing system. It would thus be helpful to reduce the ambiguity related to directors' duties in takeovers through clarification of certain terms and concepts. Given the need for flexibility, and consistently with 'cross the river by feeling its stones' paradigm,[1565] a viable option to clarify ambiguities in regulation of the board's

[1564] See page 215.
[1565] See fn 679 for explanation.

conduct in takeovers could be interpretation of directors' duties through the system of guiding cases.

Moreover, since it seems that the outcome of an individual takeover in China is more likely to be affected, if at all, by procedural rules,[1566] the proposed reform should further focus on procedural matters aimed at improving independence of non-executive directors and accountability of all directors. Strengthening their independence and accountability may be helpful in reducing board's partiality and limiting opportunities for self-serving, which in turn would lower the extend of expropriation of minority shareholders by the controllers in the takeover process. This is true especially for a country like China where, as indicated in Parts 5.6 and 5.7, the protection of minority shareholders by takeover regulation is insufficient. Even though shareholders in China are equipped with fairly extensive rights, those rights are mainly used by controlling shareholders to safeguard their interests. In contrast, minority shareholders remain insufficiently protected and without adequate *ex-post* remedies. Having a board that can act even partially independently and in the interest of *the firm and its shareholders as a whole* might be a key to effective regulation of takeovers in China for the time being. Thus, whilst the rule governing decision-making in takeovers does not necessarily need to strictly prohibit or generously allow the use of defensive measures, but the board's conduct should be delineated by more efficiently enforced responsibilities and liabilities of individual directors.

Since China wishes to attract private capital, both foreign and domestic, it must focus on providing adequate protection for minority shareholders *ex ante* and enforcement of shareholders' rights *ex post* within the takeover context as the studies indicate that the use of equity financing increases when shareholder rights protection is high.[1567] Thus, the reform should not only be limited to the Takeover Measures that directly govern directors conduct in M&A activities, but the scope of regulatory overreach requires engagement of a holistic, integrated and multifaceted approach, in which certain provisions of the corporate, securities and even competition law should be amended in a manner consistent with an overall aim of takeover regime reform.

It must nonetheless be stressed that the reform proposed in this thesis is rather unlikely to alter China's takeover market dramatically in the coming years. The proposed changes are very long term, one might say, even aspirational and they are likely to require many years until there will be any visible result.

[1566] For the discussion of the importance of procedural law *see* Lever, 'Why Procedure Is More Important Than Substantive Law' (1999) 48 The International and Comparative Law Quarterly 285.
[1567]Eg La Porta and others, 'Investor Protection…' (n1441).

7.2. Directors Role in the Takeover Context

Firstly, the reform should clarify certain ambiguities in regulation of directors conduct through the system of guiding cases. Whilst it appears that guiding cases are only persuasive[1568] they do have a significant influence on judicial decisions in China. It has been originally suggested by the author that the CSRC could assist the SPC with the selection of guiding cases to be issued, as both organs have a track record of previous collaboration on developing judicial interpretation concerning civil remedies in cases related to the securities market.[1569] Indeed, in December 2018 the SPC issued, for the first time, a list of guiding cases involving securities laws' claims – 'Ten Guiding Cases Involving Resolution of Securities and Futures Disputes'[1570]. One of the selected cases[1571] involves a claim arising from a dispute over corporate control in a listed company. However, rather than providing any guidance in regard to substantive law, the case offers an alternative method of dispute resolution to be utilised in the case of change of control disputes involving listed companies. When issuing the next batch of guiding cases, the SPC could select a case which concerns target directors' role in a context of a hostile takeover and provides guidance to the lower courts on review of the board's use of takeover defences. One of the major drawbacks of using guiding cases to interpret directors' duties would be the fact-specific character of the selected case, which may not be applicable to all the takeover scenarios and all defensive tactics used by the board. Another issue is related to the process of selecting and issuing the guiding cases. Since the SPC selects its guiding cases from the pool of already decided cases,[1572] given the very rare occurrence of hostile takeovers in China and the infrequent use of private enforcement in a takeover context, it may take a while until a suitable case emerges.

Ambiguity under Article 8 of the Takeover Measures[1573] should be clarified, especially in terms of whose interests take precedence in conflict of interests' scenarios: that of the company or of its shareholders. In China it is difficult to theoretically address the issue of the company's and shareholders' interests and whether or not they are the same in the context of hostile takeovers, because

[1568] See page 94.
[1569] International Monetary Fund, 'People's Republic of China: Detailed Assessment Report: Observance of IOSCO Objectives and Principles of Securities Regulation.' IMF Country Report (April 2012) 42. <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Peoples-Republic-of-China-Detailed-Assessment-Report-IOSCO-Objectives-and-Principles-of-25830> accessed 17 February 2018.
[1570] Zhengquan Qihuo Jiufen Duoyuan Huajie Shi Da Dianxing Anli [Ten Guiding Cases Involving Diversified Resolution of Securities and Futures Disputes] issued by the SPC, 01 December 2018.
[1571] ibid, Case No 2.
[1572] See page 93-93 for more detailed account of the procedure.
[1573] See page 115.

even the assumptions underlying basic theoretical concepts behind company law in China are not entirely clear. Although there is presently no consensus regarding what exactly constitutes the interest of shareholders in general, the dominant view in modern Anglo-American corporate law scholarship assumes that maximisation of the shareholders' wealth through maximisation of the firm's net present value (reflected in the company's share price) is the primary and most common interest of shareholders.[1574] In the takeover context, the only criteria driving directors' decision should be the impact on shareholders wealth (the share price shareholders may obtain), not the protection of other stakeholders' interests as those are already protected by contractual arrangements and regulatory solutions.[1575] Defining a single common interest of the company is more problematic. If a firm is seen as an entity,[1576] then its survival and continuity of its operations are assumed to be its principal interest, which can be achieved through the maximisation of the firm's long-term value, even if the gains are not captured by current shareholders.[1577] Takeovers, particularly hostile ones, are considered as activities that threaten the organisational identity and integrity of the firm. Advocates[1578] of the 'firm as an entity' approach claim that under such circumstances, shareholders should not be the only stakeholders considered in the board's decision-making process. The interests of other groups, such as employees and creditors, should also be taken into account and preference should be given to the long-term interest of the company should there be a conflict of interest with the immediate interests of current shareholders. The firm can also be seen as either the shareholders' property or a nexus of contracts.[1579] Since the property right view assumes that the purpose of the firm is defined by the owners' property rights and shareholders are the owners of the firm, it should be run in order to maximise their wealth. Although contractarian theory is not indistinguishably linked to shareholder primacy,[1580] it is typically assumed that the interest of a firm is reflected by the interest of its shareholders, as is currently the primary paradigm followed by the UK and the US company law.

Whilst Article 1 of the 2001 China's Governance Code referred to the shareholders as the owners of the company, the Governance Code issued in 2018

[1574] See pages 21-22.
[1575] Bainbridge, 'In Defense…'(n132) 1443-4.
[1576] See page 23 for more detailed account of the firm as an entity approach.
[1577] Guillen and Schneper (n127).
[1578] Blair (n142); Stout, 'Takeovers In...' (n1523); Lipton, 'Takeover Bids...' (n1448) 110; Blair and Stout (n112).
[1579] See pages 21-22 for more detailed account of the contractarian and private property approach.
[1580] Cheffins, 'The Team Production Model as a Paradigm' 38 Seattle University Law Review 397, 407-8.

does not. Similarly, whilst Article 42 of the 2001 Governance Code further stipulated that the board is accountable to the company's shareholders, the revised Governance Code contains no such provision. If one espouses the private propriety view of the firm, where its purpose is defined by the owners' property rights, the interest of the company in China prior to the revision of the Governance Code could be therefore personified by the interest of its shareholders because they were explicitly named the owners of the company. Given that the 2018 revision constitutes the first major amendment of the Governance Code, and that much has changed in China's corporate regime during the 17 years since enactment of the Governance Code, those amendments may indicate that shareholders are no longer considered to be the owners of listed companies and directors are no longer directly accountable to the individual shareholders. Such position is consistent with the existing Company Law, in which Article 147 states that both the duty of care and the duty of loyalty are owed to the company. This could suggest yet another move towards formal convergence with the Anglo-American model, where the company is seen as a nexus of contracts rather than being the private property of shareholders. If one assumes that China has decided to follow such a position, the substance of the corporate and takeover regimes would remain unaltered due to the implied shareholder primacy principle. In that case, the interest of the company and the interest of shareholders as a whole should be either the same or aligned, and there would be no ambiguity under Article 8 of the Takeover Measures.

If one, however, assumes that the Governance Code's revision implies adoption of an entity view of a firm, it is not clear whose interests take precedence in a conflicting interests' scenario. Whereas Article 86 of the revised Governance Code dictates that 'while maintaining the company's sustainable development, improving business performance, and *safeguarding the interests of shareholders*, listed companies should actively fulfil their social responsibilities', the same article prior to revision provided that 'while maintaining listed company's development and *maximising the benefits of shareholders*, the company shall be concerned with the welfare, environmental protection, public interests of the community in which it resides.' (emphasis added). The initial provision somehow resembled the *Unocal* standard in the US and Section 172 of the CA 2006 in the UK. The rule in China, however, alongside maintaining the company's development also explicitly stated maximising shareholders' benefit as a corporate goal and did not indicate any clear preference to the benefit of shareholders over the firm's development.

The existing version of Article 86 appears to strengthen the position of the firm's stakeholders by setting a fulfilment of social responsibilities as one of the firm's primary goals rather than, as under the old regime, requiring stakeholders' interest being considered only when maximising shareholders value and maintaining the firm's development.[1581] Moreover, departure from the strict shareholders' benefit maximisation principle towards a broader concept of 'safeguarding' of shareholders' interests may indicate that strict shareholder wealth maximisation is no longer among the primary corporate objectives. There are two alternative solutions which may be recommended in such a regime. The first involves allowing individual firms to specify their preferred goal in the articles which directors would have to primarily follow, including when discharging their duties in a takeover context. Both target shareholders and acquirers would know from the outset what to expect from directors when the company is faced with a hostile bid, and could make an informed decision whether or not to invest in the first place. The alternative solution encompasses yet another amendment of Article 86 which would clearly prioritise corporate objectives or provide some guidance to the board regarding situations when the envisaged goals conflict, including takeover offers.

The more specific issue of whether or not stakeholders should be taken into account by the target board when discharging its duties should also be addressed. It is not recommended to give the boards in China authority to defend the company against hostile suitors on the grounds of protection of stakeholders' interest in their own right. Alternatively, the interest of stakeholders could be taken into consideration by the board when contemplating the takeover offer as long as it benefits the long-term interest of the company for the benefit of its shareholders (the *Unocal* standard). However, in the absence of a clear and measurable benchmark in a takeover context such as shareholders wealth maximisation, it would be difficult to identify self-serving conduct and maintain directorial accountability. This, in turn, could open the doors for unconstrained adoption of certain types of takeover defence[1582] by directors seeking to protect their own interests rather than those of the company and its shareholders. In this light, when the company is presented with the tender offer, acting in the interest of the company should involve focusing on wealth maximisation of all corporate shareholders through attainment of the highest possible premium over market price while ensuring the highest possible probability of closing the deal by taking

[1581] Alternatively, one could interpret the amended version of Article 86 as providing that the objectives mentioned after 'while' are the primary objectives; CSR as a secondary objective is to be pursued if not in conflict with the primary ones.
[1582] Those that would not violate Article 33 of the Takeover Measures.

into account the relevant circumstances such as e.g. the necessary approvals of related authorities (similarly to *Revlon* duties). This bright-line rule strictly prohibits employing takeover defences on any other ground than the protection of (clearly defined) shareholders' interests. The interest of other corporate stakeholders could, however, be addressed without directly involving the target board in the bid's decision-making, by clarifying[1583] that when providing its recommendation on the offer to shareholders, the board, similarly to the UK[1584] and consistently with the provisions of China's Governance Code, is allowed (or perhaps even required) to consider the long-term interest of the company and its non-shareholder stakeholders. It would be consistent with the existing provision of the Takeover Measures requiring the acquirer to outline in the tender offer report any plans regarding e.g., the company's employees within the 12 months following a completed bid.[1585] Moreover, by requiring the *acquirer* to comply with plans stated in the tender offer report for a period of 12 months following the acquisition unless a qualification applies (similarly to the UK's POUs)[1586] the regime would further strengthen the position of stakeholders in a takeover context. Compliance with the post-acquisition plan should be monitored and enforced by the CSRC with help of CSRC-appointed independent financial advisor, rather than by the financial advisor hired by the acquirer, as current practice requires. Lastly, the interests of other stakeholders may be additionally protected by the introduction of the proposed public interest test which would allow the government to intervene e.g. if the interest of the firm's employees was to be seriously damaged by the contemplated acquisition.[1587]

Retaining some board authority in relation to takeover transactions, as currently prescribed by the Takeover Measures, would allow target directors to protect the interest of the company and the shareholders as a whole, subject to the strengthening of the independence of the board in the context of M&A transactions and the independence of directors generally. When the board becomes aware of a bid or of an activist shareholder preparing the proxy fight, a special committee to deal with the potential change of control should be formed by the board to deal with the takeover bid. Ideally all, but at least half of the directors sitting on the committee should be disinterested NEDs with the Chair of the committee being an independent NED. Two members of the supervisory board should be present at the committee's meetings at all times to monitor its

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[1583] The issue regarding the factors that the target board can take into account when proving recommendation is not addressed by the Takeover Measures.
[1584] See page 66.
[1585] See page 135.
[1586] See page 81 for explanation.
[1587] See page 239 for a brief description of the proposed test.

work ensuring that the process of decision-making is fair and transparent. Setting up an independent 'special takeover committee' (or one consisting of mainly independent NEDs) would help to remove interested directors from the process and balance the power of controlling and minority shareholders. A number of proposals to strengthen the general independence of directors through various corporate governance arrangements are offered below.

Firstly, the process of election of the firms' directors should be improved by making the procedures governing the nomination of candidates to the board clearer and more transparent. Similarly to the UK,[1588] listed firms should be required to make nomination and election processes more transparent by preparing a report describing the process employed in relation to the board appointments. The search for board nominees should be conducted, and appointments made, based on merit and against specified objective criteria. Due regard should be given to the benefits a diverse board, including gender, industry experience and professional background. Furthermore, public advertisement of the positions of independent NEDs would help to improve the transparency of their selection and allow access to a wider range of candidates to ensure independence. The process should be either conducted or monitored by an external agency. Although external recruitment involves extra costs and time resources, such system would limit the risk of self-selection from a narrow pool of candidates as is currently the case in China. To ensure that minority shareholders are represented on the board, adoption of cumulative voting could be strictly required for companies with a controlling shareholder pursuant to Article 17 of the Governance Code. Alternatively, similarly to the UK,[1589] apart from being elected in an ordinary manner at the general meeting, independent directors would also need to obtain a separate approval by the majority of minority shareholders. In order to avoid having those directors easily removed by the controlling shareholder, a Delaware system of prohibiting removal without cause of directors elected through cumulative voting[1590] (or those separately approved by the minority shareholders) should be adopted. To further strengthen the independence of the board, China should require its listed firms to have a separate Chair and CEO and a statutory requirement to have an independent NED as Chair. Such a separation would act as a system of 'checks and balances', decreasing the likelihood of an individual having unfettered decision-making powers. It may prove to be particularly beneficial in the context

[1588] See page 64.
[1589] See page 64.
[1590] See pages 31-32.

of hostile takeovers, as the position of the company's CEO is typically most threatened by a transaction involving change of control. Having an independent Chair, responsible for organising the board's work (and preferably the work of a special takeover committee) would ensure that the target board's conduct and the way it responds to an offer is not unduly influenced by the CEO's likely conflict of interest.

Despite a requirement imposed by the Governance Code on listed companies to assess performance of the board,[1591] the existing system of performance evaluation is rather vague and impractical. Following the UK example, China could introduce annual evaluation of the board's and individual directors' conduct by shareholders at the general meeting. Moreover, an independent financial advisor could also provide an external evaluation of the board's performance[1592] on a regular basis e.g. every three years as required by the 2018 CG Code in the UK[1593]. In order to minimise any undue influence, the independent assessor should be randomly selected from a registered database of qualified financial advisors and the board should be evaluated against certain predefined objective criteria. The results of such evaluations could be provided to the shareholders directly before any AGM involving directors' election and, perhaps, be included in the annual report and, therefore, made publicly available. Public disclosure of the assessment's results would not only strengthen monitoring, but also have reputational consequences providing for an additional disciplining mechanism of corporate directors.

Since conduct of the target board of directors and its response to a takeover offer is often highly influenced by financial advisors who are one of the key players in the Chinese takeover regime, it is vital that information provided to the board and the shareholders by the advisor is independent, precise and unbiased. The existing requirement of independence of financial advisors in the context of the takeover transactions provided by Article 17 of the M&A Financial Consultancy Services Measures should be amended as it is both over- and under-inclusive.[1594] The financial advisor must be independent from the target company, thus an advisor with financial or other connections with the target (or any such connection within the last two years) should be disqualified. A potential problem arising from the advisors being part of a multi-service company (which involves

[1591] China's CGC (n845), arts 55-57.
[1592] It is currently the function of the supervisory board to monitor and evaluate the board, but it is often believed that the board fails to fulfil its function.
[1593] CGC, provision 21.
[1594] See Part 5.6.5.

e.g., an auditor's practice) must also be recognised as it is in the UK,[1595] because of a possible conflict of interests. It is, however, recommended that China adopt a stricter approach than that of the UK to minimise such a conflict. The CSRC could impose the following restrictions: a financial advisor must not provide its services to the target directors where the advisor, or any of its affiliated entities, is the auditor of the acquirer (or has a substantial financial interest or other connection with the acquirer which may create a conflict of interests).[1596] Secondly, the M&A financial advisor should be appointed by the board's special takeover committee[1597] or independent directors, selected from accredited database of registered advisors established and maintained by the CSRC in pursuance of Article 7 of the M&A Financial Consultancy Services Measures. Moreover, similarly to the US,[1598] the financial advisor should be subject to extensive disclosure requirements, which specify any conflict of interests with the board, individual directors and controlling shareholders of both target and acquirer company. The central part of this requirement should include a report outlining the fee arrangement in M&A transactions, especially the types of fees to be paid and circumstances triggering payment of fees to the advisor. Alternatively, China could follow the UK's approach[1599] of prohibiting certain types of fees, such as 'success fees' payable to a target advisor only in the event of failure of a bid as such fees are likely to create perverse incentives which may lead to an unreliable opinion. Lastly, due to the importance and broad responsibilities of financial advisors in China's takeover regime, it is also recommended to strengthen their accountability towards the target shareholders. The general provision of the Takeover Measures which forbids abetting, assisting and colluding with the client company[1600] could be given more teeth if advisors were made directly liable for shareholders' loss caused by aiding and abetting a breach of directors' fiduciary duties, as it is in the US[1601]. Since the opinion of the financial advisor is delivered directly to shareholders, it would be reasonable to strengthen shareholders' private right of action against advisors for misrepresentation and negligent misstatement in relation to statements made during the course of the bid. This would, however, require reform of the SPC's Securities Law Provisions which currently provide that for a private lawsuit to

[1595] TC, app 3.2.
[1596] Similar to those under the HK's takeover regime contained in Securities and Futures Commission, The Codes on Takeovers and Mergers and Share Buy-backs, Schedule VII.
[1597] See page 234.
[1598] See page 54.
[1599] See page 84.
[1600] TM, art 9.
[1601] See page 55.

be admissible there is a prerequisite of imposition of an administrative penalty decision by a relevant authority or a criminal judgement made by the court.[1602]

Since, in China, directors are very often representatives of a controlling shareholder, the accountability of the latter should also be enhanced. Whilst it is beyond the scope of this thesis to provide detailed recommendations relating to this matter, it is proposed to bolster the existing fiduciary duty of controlling shareholders[1603] through issuance of guidance outlining best practices for controlling shareholders. The guidance could operate on the 'comply or explain' basis where, in case of non-compliance, such information would be included in the company's annual report explaining the rationales behind the controlling shareholder's conduct. The controller could also be evaluated by the independent external assessor against predefined standardised criteria.

Many of the changes suggested above are in line with Black and Kraakman's recommendation of a 'self-enforcing' model of corporate law for emerging economies.[1604] The central features of such a model include reliance on procedural protections, such as approval by independent directors rather than a flat prohibition of suspect categories of transactions; using bright-line rules rather than standards to define proper and improper behaviour; focus on the protection of minority shareholders; enhanced enforcement through actions by direct participants in the corporate enterprise such as shareholders and directors, rather than indirect participants such as courts and regulators; and strong legal remedies on paper, to compensate for the low probability that the sanctions will be applied in fact.[1605]

The last measure proposed refers neither to the takeover regulation nor the corporate governance measures directly, but may nevertheless improve the takeover regime. Because it was shown in Part 5.5.1.2.3 that merger control can be used relatively easily by the target boards in China to delay or even stop a hostile acquisition altogether, a proposed reform involves making certain amendments to merger control alongside strengthening the enforcement of existing laws and regulations in order to limit target directors' possibility of using the competition law as a defensive measure. Whilst the detailed proposal of revision of merger control provisions is beyond the scope of this thesis,[1606]

[1602] See page 145.
[1603] CL, art 21; China's CGC, art 63.
[1604] Black and Kraakman, 'A Self-Enforcing Model of Corporate Law' (1996) 109 Harvard Law Review 1911.
[1605] ibid 1918.
[1606] This thesis does not intend to challenge the necessity and institution of *ex-ante* merger review. In China, where many firms, in particular central SOEs, are tempted to monopolise the market, a pre-

the suggested reform includes, inter alia,[1607] optimisation of case handing mechanisms by the SAMR with the aim of shortening the overall review period[1608]; increasing fines for providing false or misleading information to deter opportunistic behaviour of the target board and to minimise its incentives to attempt to delay the takeover by obstructing the merger review; and, last but not least, either completely removing administrative intervention based on policy considerations from the merger review (which seem unlikely in the near future) or introducing a separate, clear and unbiased public interest test (independent from merger control assessment) in order to improve transparency and predictability of the overall regime. The reform would help to minimise the possibility of using merger control to deploy unregulated frustrating actions, whether by the target board or by the state. Instead of allowing the state to veto takeovers through informal, indirect and often unpredictable routes, it may be better to simply openly grant the relevant authorities with intervention rights on pre-defined and clearly outlined grounds involving public policy considerations, separate from merger control review. Allowing open state intervention in takeover activities does not constitute an ideal solution,[1609] rather a workable one which is likely to be acceptable for China's authorities. Reducing informal influence of the state on takeovers through a transparent process with clear and unambiguous procedures would help to enhance predictability of the system and manage uncertainty in relation to takeovers' outcomes.

7.3. Enforcement of Takeover Regulations

Delegates to the Third Plenum of the 11th Central Committee in 1978 declared: 'there must be laws to follow, these laws must be observed, they must be strictly enforced and lawbreakers must be dealt with'.[1610] Forty years have passed since that bold declaration and it is generally agreed that China has achieved at least one of these objectives, that of establishing a fairly complete body of laws and regulations. Yet, even today China continues to face challenges which sabotage achievement of the other goals.[1611] The situation regarding the takeover regime

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notification system may prove to be necessary. Therefore, neither the substantive nor the procedural rules of China's merger control need radical reform.

[1607] For more detailed account of proposed reform see Kruszewska, 'Impact of….' (n959).

[1608] Shichang Jianguan Zongju: Niannei Shou Dao Jingying Zhe Jizhong Shenbao 437 Jian Shenjie 380 Jian (SAMR: 437 Centralised Declarations Received During the Year, 380 of which Were Concluded) *Finance China* (16 November 2018) <http://finance.china.com.cn/news/20181116/4810987.shtml> accessed 1 December 2018.

[1609] Because eg such a review may deny shareholders the opportunity to accept beneficial offer. Moreover, a review allowing public interests considerations inevitably creates certain level of uncertainty.

[1610] Horsley, 'The Rule of Law: Pushing the Limits of Party Rule' in Fewsmith (ed), *China Today, China Tomorrow: Domestic Politics, Economy and Society* (Rowman & Littlefield Publishers 2010).

[1611] ibid

is very similar. Whilst the law regulating takeover activities including directors' conduct in takeover transactions is relatively well-developed, weak enforcement and limited accountability of violators constitute the main problem behind inadequate protection of the rights of minority shareholders. Therefore, reforming the board's conduct in the context of takeovers only on paper will be ineffective in safeguarding those interests.

Howson pointed that there are no rights without remedies[1612] which means that even the best-written laws will not fulfil their role without a successful system of enforcement. The CSRC and the SPC jointly recognised in 2016 that potent and effective *ex-post* remedial measures, whenever shareholders' lawful rights and interests have been violated or their financial interests damaged are indispensable for investor protection, which is vital to investors' trust in China's capital markets.[1613] Thus, strengthened enforcement of rules governing the market for corporate control should constitute an essential part of the overall goal of increasing market participants' confidence. Although public enforcement currently plays a major role in China's takeover regime, it is not feasible to rely solely on the CSRC to effectively monitor all takeover transactions, given the scale of the Chinese economy and its takeover market as well as the limited human and financial resources of the CSRC[1614]. Moreover, whilst the CSRC enforces securities regulations against either local SOEs or private listed companies with no substantial bias, the regulator displays a less aggressive enforcement standard in relation to central SOEs.[1615] Thus, it is also quite likely that the CSRC may have a more lenient approach to violations by politically connected boards and directors. Last but not least, a more market-based solution similar to the cold-shouldering approach provided by the Takeover Code[1616] could be introduced in China. The CSRC's regulatory power should be extended to be able to require all firms and advisors under its jurisdiction not to act for an individual or company on the basis of persistent or serious non-compliance with relevant laws and regulations.

Since the CSRC's position and regulatory powers within the takeover market has been broadly inspired by the UK's Panel it is important to remember that, as explained by Kershaw, the successful enforcement of the Takeover Code by the

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[1612] Howson, 'The Doctrine...' (n1377) 199.

[1613] 'The SPC and The CSRC Holds National Joint Conference on Promoting the Pilot Program of Multi-Dimensional Dispute Resolution Mechanism for the Securities and Futures Industries' (13 July 2016) <http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201608/t20160805_301781.html> accessed 17 April 2018. For a further discussion on 'Multi-Dimensional Dispute Resolution Mechanism' see page 245.

[1614] See Part 5.7.3.

[1615] Zhou (n1264).

[1616] TC, Introduction 11.

Panel is *sui generis* and lies in the effective self-regulation of the takeover market in the UK.[1617] It may therefore be difficult to replicate in other jurisdictions, especially China, where the supervisory authority is not independent from the state and no culture of self-regulation exists. Therefore, enforcement of takeover regulations in China should be additionally strengthened through private litigation. Apart from providing *ex-post* remedies to investors, effective private enforcement would have a deterrent effect, discouraging directors from violating laws governing takeovers.

The takeover regime needs to be made more litigation-friendly to empower minority shareholders and to make it easier to pursue actions against corporate directors and controlling shareholders who breach their fiduciary duties or other legal obligations. Reduction of the financial burden associated with litigation can help achieve this. Following Delaware's example, lawyers should be allowed to represent their clients on the basis of contingency fees arrangements. This would provide more incentives to legal professionals to pursue actions involving shareholders' interests. Although the Delaware contingency-based system is sometimes criticised as the source of an excessive M&A litigation rate and disclosure-only settlements, it is positively correlated with the number of suits brought.[1618] The level of M&A litigation is an outcome of many factors, and it is thus very unlikely that allowing contingency fee arrangements in China would suddenly increase the litigation rate to an unsustainable level. In order to protect against meritless 'disclosure-only' suits, the SPC could provide in the next set of the Securities Law Provisions that lawyers' fees would only be awarded if the supplemental disclosure agreed upon was 'plainly material', following decision of Delaware's Chancery Court in *In re Trulia Stockholder Litigation,*[1619] which significantly diminished the number of such suits.

Grounded mainly on the argument of waste of judicial resources, recommendation put forward by Wenjing Chen[1620] provides for a permission procedure similar to that in the UK involving some assessment of the merits of a claim before full evidence is presented at the trial. Wenjing Chen argues that although an unmeritorious claim can be rejected after the court's investigation, judicial resources may be wasted and the company's reputation damaged, suggesting that if the company has rejected the proposed action, the Chinese courts should be provided with information regarding the company's rejection

[1617] Kershaw, 'Corporate Law and Self-Regulation' (2015) 5 LSE Law, Society and Economy Working Papers 39.
[1618] See page 187.
[1619] 129 A.3d 884 (Del. Ch. 2016).
[1620] Chen, *A Comparative…* (n1101) 24.

and other relevant evidence which then can be taken into account by the court when deciding whether or not to grant a permission to continue the claim.[1621] While some of these arguments are plausible, the lack of a permission procedure is desirable in China (at least for the time being) given the problems discussed regarding the state of China's judiciary, such as the reported unwillingness of inexpert courts to deal with the complexity and technicality of derivative claims, a widespread local protectionism and reluctance towards accepting cases that involve a politically privileged party.[1622] Since China is characterised by an increased probability that a derivative claim or a direct lawsuit filed by a shareholder will involve the CPC group, the state or a state-affiliated agency,[1623] it is of crucial importance to address judicial lack of confidence regarding the complexity and sensitivity of such cases. In light of the above, the procedural aspect of bringing a derivative claim should therefore remain unchanged to limit courts' discretion in accepting cases based on their complexity or sensitivity. Secondly, the established system of guiding cases could be used to increase judicial confidence to deal with complex cases involving takeover-related affairs. Issuing guiding cases that address relevant matters would not only have a positive impact on judges in the lower courts but would also improve consistency in judgements and enhance legal predictability. This effect would be in line with the SPC's policy of increased standardisation of judgements across China.[1624]

Establishment of specialised courts would further contribute to resolving both issues. A study by Li Huang[1625] reported that courts in China's well-developed urban areas are more likely to comply with procedural and substantive rules than courts in less developed urban and rural areas. Such courts are also significantly less prone to local protectionism. The thesis therefore originally proposed that M&A cases should be handled by independent, specialised courts with a high level of expertise, similar to specialised bankruptcy courts[1626] and the Intellectual Property (IP) courts established in 2014 in Beijing, Shanghai and Guangzhou[1627] in response to the growing volume of IP-related disputes demanding an efficient system of rulings delivered by well-trained and

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[1621] ibid 24.
[1622] See page 146.
[1623] Howson and Clarke (n767) 247.
[1624] Woo (n1507) 262-3.
[1625] Huang, *Securities and...* (n1061) 31-32.
[1626] Li and Ponticelli, 'Going Bankrupt in China' (4 March 2019) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3251570&download=yes> accessed 20 April 2019.
[1627] Zhang 'China: Supreme People's Court Designated as Appeals Court for Highly Technical IP Cases' *Global Legal Monitor* (29 November 2018) < http://www.loc.gov/law/foreign-news/article/china-supreme-peoples-court-designated-as-appeals-court-of-for-highly-technical-ip-cases/>accessed 10 May 2018.

technologically competent judges. A similar system of centralised M&A courts would help to avoid the problem of local courts' propensity to local protectionism because of their dependence on financing from the local government.[1628] Results of a recent empirical study carried out by Bo Li and Ponticelli which investigated the effect of the introduction of specialised bankruptcy courts in China appear to confirm the validity of this argument.[1629] The study reports that cases filed in recently established specialised courts have lower resolution time compared with those handled by local civil courts. The courts are also less likely to be influenced by local governments.[1630]

As mentioned in Part 5.7.3, in 2018 China set up the Shanghai Financial Court specialising in financial and commercial matters, including disputes over securities and futures trading, new types of financial civil and commercial disputes (e.g. involving internet equity-based crowdfunding) and finance-related administrative cases where financial regulators are defendants.[1631] It might, therefore, be unfeasible to establish a separate court system to deal solely with M&A-related disputes, but certain types of cases involving takeovers could be handled by the newly established Financial Court. Due to the importance of Shenzhen as China's second financial centre and the location of the second biggest national stock exchange, a similar specialised court handing only financial and commercial matters could be established in Shenzhen. Such a proposal is consistent with the policy of capacity building and improving the professionalisation of the Chinese courts set out in the SPC's Opinions on Strengthening Financial Trials issued in 2017[1632] pursuant to which in areas where financial cases are concentrated a specialised court or financial trial collegiate bench[1633] may be established.[1634] Both Courts could serve as the court of first instance for the M&A disputes above certain monetary threshold and technically complex[1635] cases. Given the existing types of cases handled by the Shanghai Financial Court, the courts would have necessary expertise to handle cases involving takeover procedural matters outlined by the Takeover Measures. It is likely, although not certain, that the courts would be able to handle disputes arising from breach of fiduciary duties in a takeover context.

[1628] See pages 97 and 149.
[1629] Li and Ponticelli (n1626).
[1630] ibid
[1631] Shanghai Shi Gaoji Renmin Fayuan Guanyu Shanghai Jinrong Fayuàn Lu Zhi de Gonggao [Announcement of Shanghai Higher People's Court on the Performance of Duties by the Shanghai Financial Court] (21 August 2018).
[1632] Opinions on Strengthening Financial Trials (n1111).
[1633] Indeed, a specialised financial tribunal was established in 2017 within the Qianhai Court based in Shenzhen.
[1634] Opinions on Strengthening Financial Trials, 28.
[1635] Cases below the monetary threshold established, transferred from the first instance courts.

Similarly to the Beijing IP court within the area of IP law,[1636] the Shanghai Financial Court could have exclusive jurisdiction over appeals against administrative decisions of the CSRC and local governments at county level or above and civil rulings of the courts of lower instance in relation to takeovers of listed firms regardless of the monetary value of the transaction or complexity of the case.

Court-specialisation could provide a partial remedy to the low level of acceptance rates and is likely to result in higher quality and greater consistency of judgments. A specialist court is likely to make quicker decisions due to judicial familiarity with complex legal issues, valuation techniques, and new developments of capital markets related to e.g., beneficial ownership. Moreover, the courts located in China's major cities which are less likely to be involved in local politics and power struggles may be able to provide access to an independent and unbiased adjudication process of M&A cases, which will serve to increase the confidence of both foreign and private domestic investors. Financial Courts may be expected to decrease problems with the enforcement of judgements through the influence of their authority on local courts.[1637] Moreover, since defendants in takeover cases are likely to be directors with political connections or the state as a controlling shareholder,[1638] enforcement difficulties are likely to continue unless there is enhancement of the independence of local judiciary. Whilst providing detailed recommendations for judicial reform is beyond the scope of this thesis, it is unarguable that China should further promote judicial independence. Recommendations put forward by Peerenboom,[1639] Yuwen Li[1640] and Feng Lin[1641] proposing, e.g., amending the Constitution to provide constitutional protection of various elements of *de jure* judicial independence[1642] should be considered. Since judicial independence is inevitably an important element of judicial quality,[1643] or even a pillar of the rule of law,[1644] reforms strengthening judicial independence are also likely to create more favourable conditions for further development of China's capital markets

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[1636] Zhang, 'China:Supreme…' (n1627).
[1637] What may play a role in China's hierarchal society, which is believed to have roots in Confucian teaching. See page 88.
[1638] See page 146
[1639] Peerenboom, 'Judicial Independence in China' in Peerenboom (ed), *Judicial Independence in China: Lessons for Global Rule of Law Promotion* (Cambridge University Press 2009) 92.
[1640] Li, 'Judicial Independence: Applying International Minimum Standards to Chinese Law and Practice' (2001) 15 China Information 67.
[1641] Feng, 'The Future...' (n742).
[1642] See fn 473.
[1643] Melton and Ginsburg, 'Does De Jure Judicial Independence Really Matter? A Reevaluation of Explanations for Judicial Independence' (2014) 2 Journal of Law and Courts 187, 190.
[1644] 'Mt Scopus Approved Revised International Standards of Judicial Independence' (n741).

as empirical studies[1645] show that confidence in courts is an important factor in investors' decisions to invest. These measures will not altogether eliminate the enforcement problem, so further strengthening of the enforcement system (through e.g., the implementation of the Program for Solving the Difficulty in Enforcement initiated by the SPC[1646]) is essential for the proper functioning of takeover regime.

Because of China's tradition as a non-litigious society, apart from making litigation more accessible and effective, reform should also improve the functioning of alternative dispute resolution (ADR). Whilst there is an arbitral system in China for the adjudication of both domestic and international commercial disputes, mirroring the system of more mature jurisdictions in its formality and relative transparency,[1647] the author originally proposed that China should establish a comprehensive cost-effective and accessible ADR system within specialised M&A courts in order to create a 'one-stop' platform for resolving takeover-related disputes. Indeed, in mid-2016 the SPC and CSRC issued the 'National Joint Conference on Promoting the Pilot Program of Multi-Dimensional Dispute Resolution Mechanism for the Securities and Futures Industries',[1648] establishing the system of adjudication and mediation within some local courts involving securities cases in order to enhance the framework for investor protection. In May 2018 the Shenzhen Court of International Arbitration and the Shenzhen Dispute Resolution Centre jointly set up 'Mergers and Acquisitions Dispute Resolution Centre' with the objective of preventing and helping to resolve disputes arising in change of control transactions within listed firms.[1649] The author welcomes this development and further proposes the establishment of a similar dispute resolution centre in Shanghai in order to, together with Shanghai Financial Court, deal with companies listed on Shanghai Stock Exchange.

Implementation of these recommendations would send a strong signal to corporate directors, controlling shareholders and investors that China is committed to strengthening and protecting the rights and interests of all investors, and that it pursues such policy diligently. Doubts regarding the effectiveness of strengthening shareholders' rights through shareholder litigation have however been voiced by Fischel and Bradley, who assert that both the

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[1645] Ndao and others, *World Development Report 2005: A Better Investment Climate for Everyone* (World Bank and Oxford University Press 2004).
[1646] 'SPC Whitepaper 2016' (n750).
[1647] Woo (n1507) 243.
[1648] Multi-Dimensional Dispute Resolution Mechanism (n1613).
[1649] Ten Guiding Cases, Case No 2 (n1570).

theory of liability rules and available empirical evidence show that liability rules enforced by derivative suits ‘play little or no role in creating incentives for beneficial conduct’ and aligning the interest of directors with that of company’s shareholders.[1650] Romano, based on empirical research, concluded that derivative litigation constitutes an ineffective mechanism of corporate governance because both financial recoveries for shareholders and deterrence effect are weak and unsatisfactory.[1651] According to Bainbridge, the primary beneficiaries of derivative suits are lawyers rather than the shareholders themselves, as such litigation ‘mainly serves as a means of transferring wealth from investors to lawyers.’[1652] Therefore, Bainbridge suggests that derivative suits should be eliminated altogether as directors’ misconduct can be deterred by various forms of market discipline, including ‘markets for corporate control and employment, proxy contests, and shareholder litigation where the challenged misconduct gives rise to a direct cause of action.’[1653] Whilst this may be true for jurisdictions with active and well-functioning markets, these markets are unlikely to effectively fulfil their monitoring function in China in the near future due to the various factors analysed in Chapter 5. Thus, in China active private enforcement in the form of both shareholders’ direct suits and derivative claims is needed to establish and enforce accountability of corporate directors towards the company and its shareholders.

7.4. Concluding Remarks

This research provides an initial step to offer workable reform recommendations for regulating hostile takeovers in China. By analysing the takeover regimes of the US and the UK it attempts to better understand the rationales for China to transplant the regulations of these regimes and to understand the vague and unclear provisions of Chinese regulations, especially those involving conduct of the target directors. The laws, regulations and corporate governance rules adopted by more mature jurisdictions help to formulate proposals to reform China’s regulation of directors’ duties in a takeover context in line with China’s objectives of developing an active market for corporate control, better allocation of resources, attracting private foreign and domestic capital and improving the financial performance of the Chinese listed firms.

[1650] Fischel and Bradley, ‘Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Anaylsis’ 71 Cornell Law Review 261, 263.

[1651] Romano, ‘The Shareholder Suit: Litigation without Foundation?’ (1991) 7 Journal of Law, Economics, and Organization 55.

[1652] Bainbridge, ‘Is There a Case for Abolishing Derivative Litigation?’ *ProfessorBainbridge.com* (10 March 2017) <"https://www.professorbainbridge.com/professorbainbridgecom/2017/10/is-there-a-case-for-abolishing-derivative-litigation.html" \l "more"> accessed 1 December 2018.

[1653] ibid

Although calls for stricter regulation and radical reform of target directors' duties have been put forward by academics for some time,[1654] it is not necessary at this stage to fundamentally reform the substantive law regulating directors conduct in China:[1655] rather, what is predominantly needed is enhancement of the independence and accountability of directors via procedural measures as well as strengthening enforcement of the existing laws and regulations. Certain issues regarding the use of takeover defences could be addressed via issuance of guiding cases.

It also becomes clear that the ownership structure and, therefore, type of agency problems predominantly experienced by Chinese companies differ substantially in comparison to companies incorporated in the US and the UK. While China is certainly moving towards more dispersed ownership, the problems it currently faces resemble more those problems faced by countries such as Germany, the Netherlands and Hong Kong, where companies are often characterised by a concentrated ownership structure and the existence of a powerful controller. Therefore, it could be beneficial to explore the regulation of hostile acquisitions in those mature jurisdictions with more concentrated corporate ownership structure, preferably where the state is a controlling or dominant shareholder. Moreover, after having conducted a comparative analysis between takeover regulations in the UK, the US and China, it would be helpful to address in greater detail approaches towards regulation of hostile takeovers in other emerging markets with similar socio-economic characteristics, to better understand the extent of the role played by social, political and cultural factors in the regulation and enforcement of directors' conduct in a takeover context.

Lastly, whilst this thesis focused on regulation of directors' duties, it is recommended that further research into the duties of controlling shareholders (and, possibly, institutional shareholders) in a context of takeovers should be conducted.

[1654] See fn1516.
[1655] For discussion explaining the reasons see pages 226-227.

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