CHINA'S TAKEOVER LAW: A COMPARATIVE ANALYSIS AND PROPOSALS FOR REFORM

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ABSTRACT

This article is largely prompted by the two recently promulgated regulations governing takeovers in China. The goal of this article is to critically examine the legal takeover regime in China and to put forward proposals for reform. To outline the discussion, Part II describes the stock market, the takeover law, and the takeover activities in China. Two legislative goals, namely contestability of takeovers and shareholder protection, are set out in Part III. Under these principles, Part IV and Part V explore the issues of tender offer and anti-takeover defenses, respectively. Specifically, Part IV focuses on information disclosure and other major rules relating to takeovers. It appears that these rules are in line with the international norm and acceptably workable in the context of China. Furthermore, Part V explores the serious problems that are associated with anti-takeover defenses. China's law seems to be both over-inclusive and under-inclusive in this respect. After an in-depth comparative analysis of the legal regimes in the U.S., UK, and Australia, it is apparent that those regimes are not suitable for China's local conditions. Lastly, this article proposes a regime in which shareholders could veto the use of takeover defenses ex post, *while requiring that certain defensive measures be decided* ex ante. *This proposal could well suit China's needs because it not only gives shareholders sufficient protection, but also preserves necessary flexibility for management to efficiently respond to truly undesirable tender offers.*

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Some sources cited in this article were unavailable for review by the Delaware Journal of Corporate Law but have been verified by the author.

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I. INTRODUCTION

With the growing globalization of the world economy, the topic of mergers and acquisitions is becoming increasingly international.[1] For China, it has become crucial to establish a legal takeover framework that would be basically consistent with the international norm with a focus toward making China an attractive destination for foreign investors. Meanwhile, the law relating to takeovers must be in line with local situations and must meet the needs of China. China's securities market has seen remarkable progress in a relatively short period of time, but there are many problems remaining in the market that need to be addressed. In the current framework of China's securities market, takeovers play an important role. As such, China is determined to maximize the desirable effects of takeovers, such as monitoring management and promoting the efficient allocation of resources. The issue of shareholder protection is, therefore, critical to the development of the market and cannot be ignored in the process of realizing the aforementioned goals.

On September 28, 2002, China's securities market watchdog, the China Securities Regulatory Commission (CSRC), promulgated two important measures regarding takeovers designed to enhance the workability of Chinese takeover law.[2] Along with other previously enacted regulations and laws, these two make China's takeover regime appear more complete and mature. Nevertheless, this does not suggest that the takeover laws are defect free. In fact, the rule concerning takeover defenses, for example, suffers serious problems and will be thoroughly examined in this article.

The remainder of this article is structured as follows. Part II briefly presents a background of takeover law in China, including an introduction to China's securities market, a description of the framework of China's takeover law, and the current situation of takeover activities in China. Part III sets out the two goals, contestability of takeovers and shareholder protection, that Chinese takeover law is intended to fulfill. Additionally,

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[1] *See, e.g.*, Christian Kirchner & Richard Painter, *Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform*, 50 AM. J. COMP. L. 451 (2002); Robert B. Thompson, *Takeover Regulation after the "Convergence" of Corporate Law*, 24 SYDNEY L. REV. 323 (2002).

[2] Shangshi Gongsi Shougou Guanli Banfa [Measures for Regulating Takeovers of Listed Companies] (promulgated Sept. 28, 2002 and effective Dec. 1, 2002) [hereinafter Measures for Regulating Takeovers]; Shangshi Gongsi Gudong Chigu Biandong Xinxi Pilu Guanli Banfa [Measures for Regulating Information Disclosure of the Changes in Shareholdings of Listed Companies] (promulgated Sept. 28, 2002 and effective Dec. 1, 2002). For a relatively detailed description of the takeover law in China, see *infra* Part II.B.

the reasons for these two goals are examined in the context of China. Under this guideline, Part IV discusses rules regarding takeovers, and takeover defenses are covered in Part V. The two phases of a takeover are discussed in the interest of convenience because different legal relationships exist in each phase.[3] It is important to note, however, that the two parts comprise a unitary takeover law and jointly decide the extent to which the goals of contestability of takeovers and shareholder protection would be effectuated. Specifically, Part IV focuses on information disclosure and tender offer rules: the key issue being how the tender offer should be carried out by examining the relationship between the bidder company and the target's shareholders. Part V is devoted to an in-depth investigation into the takeover defenses in China and is concerned with the issue of how defensive tactics should be employed with consideration of the relationship between the target's management and target's shareholders. Additionally, Part V discusses the problems associated with takeover defenses and also advances a reform proposal on a comparative basis, taking into account the local situations in China. Finally, Part VI provides a summary, along with some concluding remarks.

II. THE BACKGROUND OF TAKEOVER LAW IN CHINA

A. *The Development of China's Securities Market*

Compared to most western countries, China's modern financial market is extremely young, having been created in the 1980s under a policy of instituted reform and openness to meet the needs of the rapidly growing economy. In 1981, a bond market was established, signifying the birth of the present-day financial market.[4] The bond market, however, only met the liquidity needs of the government, leaving unaddressed the urgent capital needs of many private enterprises.[5] Recognizing the financial difficulty private enterprises and state-owned enterprises were facing, the government responded with the establishment of two nationwide stock exchanges: the Shanghai in 1990 and the Shenzhen in 1991.[6] The two stock exchanges have jointly created an integrated equity market with nationwide coverage and made remarkable contributions to the economic development of China.

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[3]Thompson, *supra* note 1, at 324.

[4]HONG WU ET AL., ZHONGGUO ZHENGQUAN SHICHANG FAZHAN DE FALU TIAOKONG [LEGAL ADJUSTMENT OF THE DEVELOPMENT OF CHINA'S SECURITIES MARKET] 2 (2001).

[5]WEI ZHANG & LI CHU, ZHONGGUO ZHAIWU WENTI YANJIU [RESEARCH ON THE QUESTIONS OF CHINA'S DEBTS] 42 (1995).

[6]WU ET AL., *supra* note 4, at 8.

Since 1990 the stock market has grown rapidly,[7] and by the end of March 2004, the two stock exchanges were handling an aggregate of 1,302 listed companies with a market capitalization of RMB 5,041.74 billion, or roughly 614.85 billion US dollars.[8]

It is important to note that the equity structure of the Chinese stock market differs greatly from those of western nations. There are, depending on the criteria used, several different types of shares in China. Apart from the dichotomy of common and preferred shares, which looks familiar to westerners, there are other special classifications and these seem to be peculiar to China.

Of great relevance to this article is the typology of shares on the Chinese stock market. Depending on the eligible buyers and the currency in which the shares are denominated, Chinese securities are traditionally divided into two classes of shares, namely A shares, or A gu, and B shares, or B gu. A shares are the main body of shares, whereas B shares account for only about 0.4% of all the shares on China's stock market in terms of market capitalization.[9] Accordingly, B shares have a very limited impact on the Chinese stock market. A shares are basically limited to domestic investors, including individuals, legal persons, and the state, with both the principal and dividends denominated in the local currency, namely the Chinese Yuan, also known as Renminbi (RMB).[10] Foreign investors, including investors from Taiwan, Hong Kong, and Macao, can primarily invest in China's stock market by purchasing B shares, which carry the same voting and other relevant rights as common A shares.[11] Both principal and dividends of B shares are denominated in RMB, but B shares must be purchased with foreign currency.[12] Further, no companies can issue B shares unless they meet certain requirements prescribed by the government.[13] A point to note is that the prices of A shares and B shares for the same listed company are always different, sometimes by a significant degree.[14]

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[7] *Id.* at 5-6.

[8] *See* Table 2-2 Summary of Raising Capital, located on the Official Website of China Securities Regulatory Commission, *at* http://www.csrc.gov.cn/en/statinfo/index1_en.jsp?path=ROOT%eEEN%3EStatistical%20Information%3EISSuing (last visited June 18, 2004).

[9] *Id.*

[10] Qulin Fu & Tingjie Shao, *Zhongguo Zhengquan Jiaoyi Falu Zhidu Yanjiu [Study on the Legal Regime of Securities Exchange in China]* 8 (2000).

[11] *Id.*

[12] *Id.*

[13] *Id.* at 107-12.

[14] Fu & Shao, *supra* note 10, at 106.

As a distinctive Chinese characteristic, this severance of the A and B share markets is largely due to the incomplete convertibility of RMB and the so-called restricted foreign currency policy.[15] For example, precluding domestic investors from B shares is regarded as a measure to preserve the nation's foreign currency reserve. Once the RMB becomes fully convertible, the separation between A shares and B shares might disappear. In fact, increasing globalization coupled with China's accession into the World Trade Organization (WTO), has recently resulted in the gradual mitigation of this problem. Recently, in February of 2001, the B share became available to domestic investors[16] and subsequently, in November of 2002, certain qualified foreign institutional investors (QFII) have been permitted to access A shares.[17] There are, however, a very limited number of QFII and only the upper echelon of international institutional investors are likely to receive such a privilege.[18] This feature of market segmentation, therefore, is still strong and might remain so in the foreseeable future.

Second, and more important, A shares have been further sub-classified into three sub-sets in light of the strictly defined groups of shareholders in China, which are state shares (guojia gu), legal person shares (faren gu), and public individual shares (shehui geren gu).[19] Only the public individual shares are freely tradable on the stock market while a large number of the other sub-sets of shares cannot be freely traded.[20] Those non-tradable shares account for a majority of the shares in most listed companies and can only be transferred by a private takeover agreement rather than by public tender.[21] In 1998, non-tradable shares

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[15]*Id.* at 105.

[16]Guanyu Jingnei Jumin Touzi Jingnei Shangshi Waizigu de Tongzhi [Notice on Permitting Domestic Investors to Invest in B Shares] (promulgated by the CSRC on Feb. 21, 2001).

[17]Hege Jingwai Jigou Touzizhe Jingnei Zhengquan Touzi Guanli Zanxing Banfa [Provisional Measures on Investing in Tradable Shares on China's Stock Market by Qualified Foreign Institutional Investors] (promulgated by the CSRC on Nov. 5, 2002); *see also, e.g.*, Min Sun, *Domestic Stocks Open to Foreigners*, ZHONGGUO RIBAO [CHINA DAILY] (Nov. 5, 2002) (reporting that foreign investors can enter China's A share market under QFII regime).

[18]Zhaohui Yuan & Juan Ju, *The Problems of the One-Year-Old QFII System*, Zhengquan Shichang Zhoukan [Securities Market Weekly], July 17, 2004, at 12.

[19]BAOSHU WANG & QINZHI CUI, ZHONGGUO GONGSIFA YUANLI [THE PRINCIPLES OF CHINA'S CORPORATE LAW] 171 (1998).

[20]Fu & Shao, *supra* note 10, at 8.

[21]Originally, state shares could be transferred to foreigners via private agreement, yet this has been prohibited since September 1995. In November 2002, this practice was jointly revived by the China Securities Regulation Commission, the Ministry of Finance, and the China Economic and Trade Commission. *See* Guangyu Xiang Waishang Zhuanrang Shangshi Gongsi Guoyougu he Farengu Youguan Wenti de Tongzhi [Notice on Relevant Issues about Transferring State

accounted for 66.32% of the total shares in the market.[22] Empirical research has revealed that, in 1996, 74.52% of all the listed companies have a majority shareholder who holds more than thirty percent of the company's outstanding stock.[23] As of the end of May 2004, the tradable shares in the Shanghai Stock Exchange amounted to only 28.3% of all the shares, in terms of volume;[24] while during that same time the amount of tradable shares in the Shenzhen Stock Exchange amounted to 39.4%, in terms of volume.[25]

The rationale behind this unique feature of the Chinese stock market is both political and economic. The political reason is to prevent state assets from falling into the hands of individuals, while the economic reason is to protect state assets from depreciation and misappropriation (in a widely used Chinese term, *Fanzhi Guoyou Zichan Liushi*).[26]

At the beginning of the establishment of the Chinese stock market, the political reason seemed more important. Most of the listed companies in China are previously large state-owned and managed enterprises, which are seen as the basis and symbol of a socialist economy. When these enterprises initially went public, their original state assets translated into state shares of the listed companies.[27] Thus, those state shares are labeled as state assets, which, in turn, represent the state's ownership. State ownership is traditionally considered the highest form of ownership and the goal of socialism. After the 1999 amendment, the Chinese Constitution still provides that

> in the primary stage of socialism, [China] shall uphold the basic economic system in which *public ownership is dominant* and diverse forms of ownership develop side by side. It shall also uphold the distribution system with

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Shares and Legal Person Shares of Listed Companies to Foreigners] (Promulgated in Nov. 2002).

[22]Ling He, *Empirical Analysis on the Corporate Governance in Chinese Listed Companies*, 5 JINGJI YANJIU [ECONOMIC STUDY] 45 (1998).

[23]*Id.*

[24]See the official website of Shanghai Stock Exchange, *at* http://www.sse.com.cn/sseportal/webapp/datapresent/MarketViewAct?reportName=NumberOfListing (Market Overview) (last visited June 18, 2004).

[25]See the official website of Shenzhen Stock Exchange, *at* http://www.szse.cn/UpFiles/Attach/1468/2004/06/03/1526155937.html (Market Overview) (last visited June 18, 2004).

[26]HEHONG CHEN ET AL., GUOYOU GUQUAN YANJIU [STUDY ON STATE-OWNED SHARES] 324 (2000).

[27]*Id.* at 81-83.

> distribution according to work remaining dominant and with a variety of models of distribution coexisting.[28]

Individual ownership is still seen as inferior to public ownership and is treated differently. The 1999 amendment to Article 11 of the Chinese Constitution reads as follows:

> the non-public sector, including self-employed and private businesses, *within the domain stipulated by law, is an important component of [China's] socialist market economy.* The state shall protect the legitimate rights and interests of the self-employed and private enterprises, and China should also exercise guidance, supervision and management over them according to the law.[29]

Prior to this amendment, private businesses enjoyed an even lower status and were considered just a *complement* to the socialist public sector economy. Under this social and political framework, state shares, as the embodying form of state ownership, have been strictly protected from the threat of private ownership. It was feared that if state shares were permitted to be transferred to private owners, then the socialist economy would be baseless. Thus, the prohibition of the free transfer of state shares serves to preserve the socialist nature of the Chinese economy and thus China as a whole.

The economic reason to restrict the transfer of state shares is the fear that, if transferred, state shares could be mishandled or at the least lose value. Because the Chinese stock market was deemed an experiment of economic reform at the outset,[30] the government was understandably reluctant to risk state assets in this experiment. The original purpose of the

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[28]ZhongHua Renmin Gongheguo Xianfa [The Constitution of the People's Republic of China] art. 6 (emphasis added) [hereinafter China's Constitution].

[29]*Id.* art. 11 (1999 amendment) (emphasis added).

[30]In early spring of 1992, China's leader, Deng Xiaoping, made an important speech during the inspection of South China that was intended to liberate minds and encourage further reform. With respect of the stock market, he pointed out,

> Are securities and the stock good or bad? Do they entail any dangers? Are they peculiar to capitalism? Can socialism make use of them? We allow people to reserve their judgment, but we must try these things out. If, . . . they prove sensible, we can expand them. Otherwise, we can put a stop to them.

Deng Xiaoping, *Excerpts from Talks Given in Wuchang, Shenzen, Zhuhai and Shanghai* (Jan. 18-Feb. 21, 1992), *in* 3 DENG XIAOPING, SELECTED WORKS OF DENG XIAOPING 361 (The Bureau for Compilation and Translation of works of Marx, Engels, Lenin and Stalin under the Central Committee of the Communist Party of China trans., Foreign Languages Press, 1994).

establishment of the stock market, and perhaps even now to a large degree, was to raise funds for state-owned enterprises and to help those enterprises get out of financial distress, so called *Wei Guoyou Qiye Jiekun*.[31] Other than that purpose, the Chinese government has little interest in seeing its shares transferred.

As the economic and political reform in China increases, the concern over the transfer of shares decreases. Over time, the original experimental nature of the stock market has faded, and the market seems to function healthily and play a more important role in the Chinese economy. Thus, the government currently feels that it might be safe to let state shares into the market.[32]

At present, there is perhaps a more important reform needed because the majority of the shares on the market are non-tradable and present a much more serious impediment to the further development of the market.[33] In particular, in the face of such a high percentage of non-tradable state shares in listed companies, takeover attempts by tender offer are practically impossible.[34] Further, the government is beginning to recognize that state shares could maintain their value, and perhaps even appreciate, by transfer on an open market. Thus, the government has decided to sell most of the state shares, so called *Guoyougu Jianchi*,[35] but this has been temporarily locked up due to a disagreement on the selling price of state shares since June 24, 2002.[36] The deadlock is largely based on the fact that the price of tradable shares is usually higher, sometimes significantly, than the price of non-tradable shares in the same company.[37] Another reason is that the tradable shares have always been much more expensive than state shares when the companies initially went public. Thus, the tradable-share holders

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[31]*See, e.g.*, Guogang Wang, *Reform the Planned Economy System and Protect Investor Interests*, JINGJI CANKAO BAO [ECONOMY GUIDANCE NEWS], Jan. 29, 2004 (contending that the market's purpose of raising funds for state-owned enterprises should be changed). *See also* Xiaonian Xu, *China's Securities Market is now Experiencing Structural Change*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES NEWS], Nov. 29, 2000 (arguing that China's securities market should no longer primarily serve as a tool for state-owned enterprises to raise funds).

[32]WANG & CUI, *supra* note 19, at 328-30.

[33]*Id.* at 318-19.

[34]Fu & Shao, *supra* note 10, at 231.

[35]Jianchi Guoyougu Chouji Shehui Baozhang Jijin Guanli Zanxin Banfa [Provisional Measures on Selling State Shares to Raise Social Security Fund] (promulgated by the State Council on June 12, 2001).

[36]Jian Lin, *The State Council has Decided to Stop Selling State Shares*, SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], June 24, 2002, at 1.

[37]CHEN ET AL., *supra* note 26, at 168.

are strongly opposed to the government's plan to sell state shares at market price.[38]

In addition to the tradable and non-tradable distinction, there are distinctions based on the location of where certain stocks are listed, such as H shares and N shares. H shares and N shares, for example, took their names from the location where the shares are listed. Respectively, H shares are stocks of Chinese companies listed on the Hong Kong Stock Exchange, while N shares are those listed on the New York Stock Exchange. The trading of these shares is mainly subject to the laws of listing locations rather than Chinese laws. Additionally, the market capitalization overseas of such shares is rather small, only 2.3% of the domestic market capitalization of A shares and B shares.[39] Therefore, these shares have very little impact on the Chinese stock market. Notwithstanding their diminished relevance to this discussion, they are noted for the sake of completing the picture of China's stock market.

Finally, it is important to keep in mind that the aforementioned features of China's stock market have significantly affected takeover activities.

B. *The Framework of China's Takeover Law*

In accordance with the step-by-step development of the underlying stock market, as Chinese securities laws evolve over time, so does the regulatory regime. Before October 1992, the regulatory regime was made up of a group of provincial regulatory bodies that operated relatively independently of each other under the directions of respective local governments.[40] This non-centralized regulatory regime, however, was insufficient.[41] Accordingly, in October of 1992, the central government established the State Council Securities Commission (SCSC) and the China Securities Regulatory Commission (CSRC),[42] thus marking the beginning of the uniformity of the national securities regulatory system.

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[38]*See, e.g.*, Zhiguo Han, *Eight Errors of the Plan to Sell State Shares*, SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Nov. 5, 2001, at 3. Further discussion of this problem goes well beyond the scope of this article.

[39]See Official Website of the CSRC, *supra* note 8.

[40]*See* Official Website of the CSRC, *at* http://www.csrc.gov.cn/cn/homepage/about.jsp (last visited June 18, 2004); *see also* WU ET AL., *supra* note 4, at 9 (2001) (discussing China's early securities regulatory regime).

[41]*See, e.g.*, Jinxuan Bao, *Improve the Securities Regulatory and Self-Regulatory Regime in China* (*Lun Woguo Zhenquan Jianguan yu Zilu Tizhi Jiqi Wanshan*), 3 FASHANG YANJU (STUDY ON LAW AND COMMERCE) 66 (1999).

[42]Official Website of the CSRC, *supra* note 40.

Under this scheme, the SCSC was the national authority responsible for the regulation of the securities market, and the CSRC, the SCSC's executive branch, was charged with supervisory responsibility over the securities market nationwide, in collaboration with local regulatory bodies.[43] Because the regional securities regulatory bodies were preserved after this reform and were controlled by local governments, the friction and confusion with respect to regulatory powers continued to remain.[44] In order to further enhance the efficacy of the regulation of the market following a flood of securities fraud scandals in 1997, the central government streamlined the regulatory regime by putting the local securities regulatory authorities under the direct supervision of the CSRC in November of that same year.[45] Due to the growing influence and role of the CSRC in securities regulation, it was merged with the SCSC in April of 1998,[46] thus resolving the conflict between the two. Consequently, the CSRC was upgraded into a ministry rank unit directly under the leadership of the central government,[47] further strengthening both the powers and functions of the CSRC. Later a centralized regulatory regime was finalized and the CSRC has been enjoying the exclusive authority to regulate securities in China.[48]

The first influential regulation containing takeover provisions was the Provisional Regulations for the Administration of Stock Issuance and Transaction (Provisional Regulations), promulgated by the State Council Securities Commission in 1993.[49] This regulation is still in effect now even after the Securities Law came into force in 1999.[50] In 1999, the Securities Law of the People's Republic of China (Securities Law) has paid considerable attention to takeover activities by devoting the entirety of

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[43]*Id.*

[44]*Id.*

[45]*Id.*

[46]Official Website of the CSRC, *supra* note 40.

[47]*Id.*

[48]*See id.*; WU ET AL., *supra* note 4, at 9-10.

[49]Gupiao Faxing Yu Jiaoyi Guanli Zanxing Tiaoli [Provisional Regulations for the Administration of Stock Issuance and Transaction] (promulgated Apr. 22, 1993) [hereinafter Provisional Regulations].

[50]Company Law of the People's Republic of China regulates some aspects of mergers and acquisitions but does not specifically relate to takeovers. Zhonghua Renming Gongheguo Gongsi Fa [Company Law of the People's Republic of China] (promulgated Dec. 29, 1993 and effective July 1, 1994) [hereinafter Company Law]. Chapter 7 of the Company Law is titled Merger and Division of Companies.

Chapter 4 to takeovers.[51] This, however, still appeared to be incapable of meeting the need of regulating takeovers.

In response to this, the CSRC promulgated the Measures for Regulating Takeovers of Listed Companies (Measures for Regulating Takeovers)[52] and the Measures for Regulating Information Disclosure of the Changes in Shareholdings of Listed Companies (Measures for Disclosure)[53] in September of 2002. These two regulations contain fairly detailed provisions with respect to the takeover activities and have filled most of the legal loopholes found in previous provisions. For example, the Measures for Disclosure added a provision about the notion of "people acting in concert" in the course of takeovers;[54] The Measures for Regulating Takeovers provides a clear list of the situations where the mandatory bid could be exempted, as well as the concrete procedures to be applied to it.[55] These two regulations have completed the takeover laws as a whole[56] and are expected to promote the "sustained and healthy" development of takeover activities.[57]

In all, China's securities market now is under the centralized regulation of the CSRC and the legal framework regarding takeovers in China consists of a range of laws and regulations as previously described above. The takeover law has provided a solid legal groundwork for the acceleration of takeovers. This is certainly a remarkable achievement, given the short history of the development of China's securities market. This being said, this author must point out that the law is far from perfect, especially in the area of takeover defenses, and these problems will be the focus of this article.

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[51]Zhonghua Renming Gongheguo Zhenquan Fa [Securities Law of the People's Republic of China] (promulgated Dec. 29, 1998 and effective July 1, 1999) [hereinafter Securities Law].

[52]Measures for Regulating Takeovers, *supra* note 2.

[53]Shangshi Gongsi Gudong Chigu Biandong Xinxi Pilu Guanli Banfa [Measures for Regulating Information Disclosure of the Changes in Shareholdings of Listed Companies] art. 6-9 (promulgated Sept. 28, 2002 and effective Dec. 1, 2002) [hereinafter Measures for Disclosure].

[54]*Id.* art. 9.

[55]*Id.* ch. 4, including arts. 48 to 53.

[56]Like other regulations promulgated by the CSRC, these two regulations are potentially vulnerable to the longstanding criticism that the CSRC, as an enterprise unit of the State Council, has no capacity to formulate regulations under China's administrative law. *See* Xuejun Shen, *Woguo Zhenquan Jianguan Falu Zhidu Moshi* [*Institutional Mode System on Supervising Securities Market in China*], XIANDA FAXUE (MODERN LAW SCIENCE) 116, 118 (Apr. 2001). Because this problem is not unique to these two regulations, it is beyond the scope of this article.

[57]These two regulations, therefore, have been lauded by the market. *See* Xiao Zhang, *New Rules to Encourage M&As*, ZHONGGUO RIBAO [CHINA DAILY], Oct. 9, 2002, at 2.

C. *Overview of Takeover Activities in China*

In China there is currently confusion about using the term "takeover," which has been translated as *Binggou* (or *Shougou, Hebing, Jianbing, Chongzu*) in Chinese. These Chinese words are frequently used interchangeably, of which *Binggou* is the most common. *Binggou* has a very amorphous conceptual boundary and seems to be capable of expressing all the meanings of these English words: takeover, merger, acquisition, consolidation, amalgamation, and even sometimes internal capital reorganization of a company.[58] What *Binggou* exactly means depends on the particular circumstances in which it is used. For the purpose of this article, takeover or *Binggou* is defined as the trading activities on the shares of listed companies with a view toward acquiring corporate control. From 1993 to the end of 2002, there have been about 160 takeover cases, involving about 60 billion Renminbi, roughly US$ 7.31 billion.[59]

There are currently two methods of takeover in China: one is takeover by tender offer; the other is takeover by private agreement.[60] As discussed earlier, A shares on China's stock market comprise tradable shares and non-tradable shares.[61] Tradable shares, mainly public individual shares, can be purchased by tender offer, whereas non-tradable shares, consisting of state shares and legal person shares, can only be transferred by private agreement.[62]

As previously shown, the predominant feature of China's stock market at present is that listed companies commonly have a highly concentrated ownership structure with the state as the controlling shareholder and more importantly, the majority of shares are non-tradable.[63] In order to successfully acquire the control of a listed company, one has to acquire the non-tradable shares by private agreement. Takeover by private agreement, therefore, has long been the main takeover method for acquiring

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[58]Xiangqu Li et al., *Research on Some Legal Issues Relating to the Capital Reorganization and Share Transfer of Listed Companies*, 2 SHANGZHENG YANJIU [SHANGHAI STOCK EXCHANGE RESEARCH] 1, 3 (2003) (advocating that the concept of takeover and capital reorganization should be classified).

[59]Xiaobing Jin et al., *Research on Some Issues about Takeover Legal Regime for Listed Companies*, 2 SHANGZHENG YANJIU [SHANGHAI STOCK EXCHANGE RESEARCH] 191, 192 (2003).

[60]Securities Law, *supra* note 51, art. 78. Takeover by tender offer in China is similar to that defined through an eight-factor test in the U.S. *See, e.g.*, Wellman v. Dickinson, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979).

[61]*See supra* Part II.A.

[62]Fu & Shao, *supra* note 10, at 217-19.

[63]*See supra* Part II.A.

control of a listed company in China. Thus, the government can effectively control the transfer of state shares. According to the Securities Law, "When the takeover of a listed company involves shares held by an investment organization by the State, the matter shall be subject to approval by the relevant department in charge in accordance with the regulations of the State Council."[64]

For this reason, takeover by tender offer is not popular or feasible in China. To date, a very limited number of takeover cases by tender offer in China have occurred and almost all of the target companies had few non-tradable shares.[65] For example, the first takeover case by tender offer in China occurred in 1993, which targeted a small company that was free of non-tradable shares.[66] This was a common feature shared by many other cases.[67]

If, as discussed earlier, the government successfully sells the state shares and thus all the shares become tradable (so called *Quanliutong*), there will be more takeovers by tender offer in China. After the promulgations of Measures for Regulating Takeovers and Measures for Disclosure, there has been an increase in the number of takeover cases by tender offer.[68] This article will primarily focus on the regulations concerning the transactions of the A shares, which are tradable through tender offers. Any sensible conclusion, however, could not be reached without taking the current special equity structure of Chinese companies into account.

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[64]Securities Law, *supra* note 51, art. 94.

[65]Ming Cha, *Analysis on the Features of Two Cases of Tender Offer*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES NEWS], Apr. 23, 2003, at 5.

[66]In September 1993, Shenzhen Baoan Enterprises, a Shenzhen legal person company, attempted the first hostile takeover of a Chinese public company by accumulating a large block of the publicly traded shares of Shanghai Yanzhong Industrial, a listed company in Shanghai. This takeover failed after the CSRC intervened because Shenzhen Baoan was found to have breached takeover disclosure rules and the takeover involved a short swing. *See* China Securities Regulatory Commission, Decision of the China Securities Regulatory Commission on the Punishment of the Shanghai Subsidiary Company of Shenzhen Baoan Group Company, the Baoan Huayang Health Care Production Company, and the Shenzhen Ronggang Baoling Electrical Lighting Company for Breaching the Securities Regulations, 4 ZHONGGUO ZHENGQUAN JIANDU GUANLI WEIYUANHUI GONGGAO [CHINA SECURITIES REGULATORY COMMISSION OFFICIAL BULLETIN] (Oct. 25, 1993).

[67]In another case, Shenzhen Vanke, a Shenzhen company, attempted to acquire control of Shanghai Shenhua Industrial, a Shanghai publicly traded company, which had a total of 27 million shares outstanding, of which there were no state shares. *See* Christine Chan, *Shenhua Stake Cost Vanke 39M Yuan*, NANHUA ZAOBAO [SOUTHERN CHINA MORNING POST], Nov. 15, 1993, Business, at 3.

[68]NanGan Gufen and Chengshang Group were the target companies, respectively, in two cases of takeover by tender offer. *See* Cha, *supra* note 65, at 5.

III. SHAREHOLDER PROTECTION AND THE CONTESTABILITY OF TAKEOVERS: TWO GUIDING PRINCIPLES

Takeover regulation appears to occupy a significant place in the corporate laws of various jurisdictions and the socio-economic effects of such regulations have been widely debated. In discussing the appropriateness of takeover law in China, it is this author's view that we must keep in mind two principles: (1) shareholder protection and (2) the contestability of takeovers. These two principles have also been expressly endorsed by the CSRC in Article one of the Measures for Regulating Takeovers, which reads:

> According to Company Law, Securities Law and other laws and relevant administrative regulations, this measure is enacted in order to standardize the takeover activities of listed companies, stimulate the optimization of the resource allocation on the stock market, protect the lawful rights and interests of investors, safeguard the normal order of the stock market.[69]

The two principles may be consistent in some instances, while in other situations they may be diametrically opposed. As will be shown, the issue of designing the best possible takeover law consists of nothing more than trying to strike a balance between the two guiding principles.

A. *Contestability of Takeovers*

Takeovers, especially hostile takeovers, have been long regarded as an effective mechanism of monitoring the management of corporations and, as such, are beneficial to the enhancement of corporate governance.[70] Faced with the possibility of a hostile takeover, managers have an incentive to manage more efficiently, thus creating shareholder value.[71] This aids in

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[69]Measures for Regulating Takeovers, *supra* note 2, art. 1.

[70]Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 756 (1997) (stating that "[t]akeovers are widely interpreted as the critical corporate governance mechanism . . . without which managerial discretion cannot be effectively controlled").

[71]Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169 (1981). "The most probable explanation for unfriendly takeovers emphasizes their role in monitoring the performance of corporate managers. The tender bidding process polices managers whether or not a tender offer occurs, and disciplines or replaces them if they stray too far from the service of the shareholders."

aligning the interests of management with the interests of the shareholders and thus reduce the agency costs of management.[72]

The benefit of takeovers has been positively recognized by legislators. In debating the bill which would later become the *Williams Act* in the U.S., Senator Williams stated that " [i]n some instances, a change in management will prove a welcome boon for shareholder and employee, and in a few severe situations it may be necessary if the company is to survive."[73]

In addition, takeovers are also thought to improve the allocation efficiency of scarce social resources to the benefit of the society as a whole. Takeovers ensure that the resources are utilized by the most capable people and yield the maximum returns.[74] Further, takeovers could create value for shareholders by providing them with a substantial premium upon the sale of their shares.[75]

Id.

[72]*Id.* at 1173.

> Tender offers are a method of monitoring the work of management teams. Prospective bidders monitor the performance of managerial teams by comparing a corporation's potential value with its value (as reflected by share prices) under current management. When the difference between the market price of a firm's shares and the price those shares might have under different circumstances becomes too great, an outsider can profit by buying the firm and improving its management. The outsider reduces the free riding problem because it owns a majority of the shares. The source of the premium is the reduction in agency costs, which makes the firm's assets worth more in the hands of the acquirer than they are worth in the hands of the firm's mangers.

On the role of the takeover as a mechanism for monitoring management performance and thus reducing the agency cost, see also Gregory R. Andre, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 DEL. J. CORP. L. 865 (1987); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. OF POL. ECON. 110, 113 (1965).

[73]113 CONG. REC. 854 (1967) (statement of Sen. Williams).

[74]*See, e.g.*, John C. Coffee Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1221 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 705 (1982); Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. OF ECON. PERSP. 21, 23 (1988).

[75]Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, *in* KNIGHTS, RAIDERS, AND TARGETS, THE IMPACT OF THE HOSTILE TAKEOVER 314 (John C. Coffee, Jr. et al. eds., 1988) (stating that "[t]akeovers benefit target shareholders—premiums in hostile offers historically exceed 30%, on average, and in recent times have averaged about 50%"). *See also* Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control, The Scientific Evidence*, 11 J. FIN. ECON. 5, 9-16 (1983) (arguing that target shareholders can benefit from takeover premiums); Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices As An Acquisition Motive*, 88 COLUM. L. REV. 891, 908 (1988) (observing that target shareholders can be better off selling shares at a premium).

This pro-takeover argument, however, is not without criticism. A powerful counterargument is that the threat of a hostile takeover forces managers to emphasize short-term gains and "paper profits."[76] Under this view, management puts the short-term concerns ahead of long term concerns in making decisions. In other words, managers would be reluctant to devote corporate resources to research and development of new products and technologies. Thus, shareholders would not receive long-term value for their investment.[77] Apart from this, hostile takeovers have also been regarded as leading to lost productivity from business disruption, creating dangerously leveraged capital structures and causing inefficiency by diverting managers from *real* economic activity to financial reshuffling.[78] More severely, this might result in national industries losing their competitiveness in the international market.[79]

The anti-takeover stance, however, has also been attacked. It has been opined that all the anti-takeover claims are "impressionistic" and largely based "on anecdotal evidence."[80] Acknowledging that those claims

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[76]Jensen, *supra* note 75, at 319-20.

> It has been argued that growing institutional equity holdings and the fear of takeover cause managers to behave myopically and therefore sacrifice long term benefits to increase short-term profits. . . . There is little formal evidence on the myopic-manager issue, but I believe this phenomenon does occur. Sometimes it occurs when managers hold little stock in their companies and are compensated in ways that motivate them to take actions to increase accounting earnings rather than the value of the firm. It also occurs when managers make mistakes because they do not understand the forces that determine stock values.

[77]*See, e.g.*, Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 837 (July 1993).

[78]*See, e.g.*, Peter F. Drucker, *Drucker on Management: Taming the Corporate Takeover*, WALL ST. J., Oct. 30, 1984, at 30, col. 3.

[79]In the 1980s, some criticized takeover activities as counterproductive to American industry and attributed the decline of America's competitive advantage to this reason. *See, e.g.*, *id. See also* Jensen, *supra* note 77, at 837 (quoting Martin Lipton, Corporate Governance: Major Issues for the 1990's Address to the Third Annual Corporate Finance Forum at the J. Ira Harris Center for the Study of Corporate Finance, University of Michigan School of Business (Apr. 6, 1989)).

> Indeed, Marty Lipton, prominent defender of American CEOs, expresses a common view of the 1980s when he states that "the takeover activity in the United States has imposed short-term profit maximization strategies on American Business at the expense of research, development and capital investment. This is minimizing our ability to compete in world markets and still maintains a growing standard of living at home."

[80]Coffee, *supra* note 74, at 1153-54.

> Some of these critics have advanced broad claims, arguing either (a) that hostile takeovers produce only "paper profits" and a preoccupation with short-run profit maximization, which undesirably divert management's attention from the pursuit of greater operational efficiency, or (b) that the stock market is so inefficient as to make it unlikely that tender offers will focus selectively on companies with

appear to have gained some influence, other commentators have argued that such claims were untenable due to the lack of the support from conclusive empirical evidence.[81] Others, notably Easterbrook and Fischel, aggressively contend that management's fear of takeovers would not, as the anti-takeover claim posits, necessarily give rise to short-term strategies on the grounds that "[i]f the market perceives that management has developed a successful long-term strategy, this will be reflected in higher share prices that discourage takeovers."[82]

The debate over the economic value of takeovers remains largely inconclusive and, as such, will continue in the foreseeable future, as will the relevant empirical studies. As with most legal debates, the issue of takeovers cannot be sensibly examined without taking account of the specific context in which takeover activities operate. In the face of the contrasting effects associated with takeovers, we must prioritize them by analyzing the needs of the specific situations in question.

In China, the problem of corporate governance is particularly serious due to various reasons. The lack of supervision of management is generally thought to be at the heart of the issue.[83] There are, in theory, at least several mechanisms for monitoring management in China. First, according to Company law, shareholders have the power to monitor managers.[84] State-owned shares, however, occupy a high percentage of all the outstanding shares in most listed companies. Due to the problems of agency costs and an omnipresent bureaucracy, the state as the majority

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> inferior managements. These assertions suffer serious flaws: the first claim is essentially an impressionistic critique that relies chiefly on anecdotal evidence and never explains adequately why shareholders should not be able to determine the optimal time frame within which the profits are to be maximized in the business they own.

Id. (footnotes omitted).

[81] *See* Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1955 (1991).

> These [anti-takeover] claims are all controversial, which at least partially explains why the United States Congress has failed to pass takeover legislation despite many hearings and legislative proposals in recent years. No conclusive empirical evidence resolves any of these claims, although most academics believe that the available evidence tilts decidedly in favor of takeovers.

Id. (footnotes omitted).

[82] Easterbrook & Fischel, *supra* note 71, at 1183-84 (asserting that "[t]he threat of takeovers does not prevent managers from engaging in long-range planning").

[83] *See, e.g.*, Junhai Liu, *Prospect for China's Corporate Law Reform After the Entry into WTO*, *in* CORPORATION LAW REFORM FOR A GLOBAL COMPETITIVE ECONOMY 254, 270 (Baoshu Wang et al. eds. 2003).

[84] Company Law, *supra* note 50, art. 103 (listing the powers of the shareholders' general meeting).

shareholder has long seemed to be virtually non-existent with respect to the monitoring of management.[85] This unique phenomenon is called *Guoyougu Suoyouzhe Quewei* (no functional proprietor of the state-owned shares).[86] Second, the two-tier corporate governance system in China has resulted in a specifically designed supervisory board to monitor directors and corporate officials.[87] Unfortunately in practice, the supervisory board has proved to be ineffective in serving its purported function.[88]

It is important to note that China has yet to establish a derivative suit system, which is widely believed to be an effective management-monitoring device.[89] Recently, China has attempted to introduce a system utilizing independent directors, which was primarily modeled after the U.S. system, with a focus on remedying the deficiency of management monitoring.[90] So far, this practice suffers from many problems and has not solved the targeted management-monitoring issue as originally expected.[91]

As Shleifer and Vishny have pointed out, "takeovers are widely interpreted as the critical corporate governance mechanism in the United States, without which managerial discretion cannot be effectively controlled."[92] In the context of China, it appears that the monitoring mechanism at the heart of corporate governance is far more severe than in

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[85]CHEN ET AL., *supra* note 26, at 247-48.

[86]In response to this issue, the central government established a specific administrative body known as the State-owned Asset Supervision and Administration Commission of the State Council (SASAC), and placed the SASAC in charge of state-owned assets in 2003. Whether this new body will satisfactorily fulfill its important role is uncertain at the moment. *See* Jiahang Wang, *How to Establish an Effective SASAC*, JINGJI SHIBAO [ECONOMY NEWS], Feb. 19, 2003, at 4.

[87]Company Law, *supra* note 50, art. 127.

[88]Shenshi Mei, *The Roles of Supervisors and Supervisory Board in Modern Corporate Governance*, 1 SHANGSHIFA LUNJI [COMMERCIAL L. REV.] 161, 195 (1995);Fengting Yin, *Urgently Needed to Improve the Function of Supervisory Boards in listed Companies*, SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Dec. 4, 2003, at 12.

[89]Hui Huang, *Research on Shareholder Derivative Suit*, 7 SHANGSHIFA LUNJI [COMMERCIAL L. REV.] 332 (2002).

[90]*Guanyu zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian [Guiding Opinion on Establishing Independent Directors System in Listed Companies]* (promulgated by CSRC in Aug. 16, 2001); Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1, 46.

[91]Some Chinese commentators have satirized independent directors as decorative vases, and as such have little function. *See, e.g.*, Jianxiong Wu et al., *What is Wrong with Independent Directors: An Empirical Study on the Current Situation of Independent Directors in China*, ZHENGQUAN SHIBAO [SECURITIES TIMES], Jan. 10, 2002, at 9.

[92]Shleifer & Vishny, *supra* note 70, at 756 (citation omitted).

the U.S. and is the primary problem in need of a solution.[93] Thus, the management-monitoring value of takeovers should have preference (at least at this stage of China's economic development).

Furthermore, China is transitioning from a centrally planned economy to a market-oriented economy and many problems exist regarding the inefficiency of the allocation of resources. Thus, whole industries urgently need to be restructured to optimally employ social resources. By reforming the takeover framework, China could improve the efficiency of management, optimize the allocation of social resources, enhance corporate governance, and boost the international competitiveness of its industries as a whole. After China's entry into the WTO, it has become crucially important to hasten the process of achieving these goals in order to survive in an increasingly competitive world economy. A vigorous corporate control market is central to the realization of this goal, and China needs to take a pro-takeover stance.

This situational policy orientation has been recognized in the Measures for Regulating Takeovers, which expressly states that its legislative purpose is to "regulat[e] takeover activities, improv[e] the optimal allocation of the resources on the securities market, and protect[] the legitimate rights of investors."[94] As the former Chairman of the CSRC, Zhou Xiaochuan, commented on the two new rules: "Through mergers and restructurings, China's capital market will play an active role in better integrating the nation into the world economy and ensuring smoother economic transition and structural adjustment."[95] Therefore, maintaining the contestability of takeovers should be one of the principles underlying the takeover regime.

B. *Shareholder Protection*

In addition to maintaining the contestability of takeovers to achieve the management monitoring value, another crucial principle with respect to takeovers is shareholder protection—more specifically, the protection of existing shareholders and their companies from unwanted takeovers and the protection of individual shareholders from unjust treatment during takeovers. In other words, the legal takeover framework must ensure fairness and justice in the course of takeover activities, while at the same

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[93]*See generally* Schipani & Liu, *supra* note 90, at 47-51 (describing common misuses of power by Chinese executives and comparing them to the accountability of their American counterparts).

[94]Measures for Regulating Takeovers, *supra* note 2, art. 1.

[95]Zhang, *supra* note 57.

time promoting economic efficiency.

Hansmann and Kraakman, among others, have asserted that "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value."[96] This shareholder protection principle is particularly prominent in circumstances where the takeovers are instituted by corporate raiders. In such a situation, there is a real possibility that some acquirers would expropriate the wealth of the existing shareholders, and thus the target company shareholders would be harmed by the takeover.[97] This phenomenon has a long history[98] and eventually prompted the enactment of various takeover-oriented legislation, such as the *Williams* Act[99] in the U.S. and in other jurisdictions including China. The protection of investors is mainly achieved by requiring adequate information disclosure and specifying certain rules concerning tender offers.[100] In Australia, for example, the Eggleston principle was introduced in 1969 with a view to the attainment of shareholder protection,[101] and has been viewed as "the product of the

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[96]Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 439 (2001).

[97]Thompson, *supra* note 1, at 325.

[98]John Coffee has advanced the theory that investment bankers of the late nineteenth century performed the function of protecting "the public shareholder from attempts by speculators to steal a firm's control premium." *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 31 (2001).

[99]Pub. L. No. 90-4393, 82 Stat. 454 (1968), *codified as amended at* 15 U.S.C. §§ 78m(d)-(f), 78n(d)-(f) (2000).

[100]RICHARD W. JENNINGS ET AL., SECURITIES REGULATIONS: CASES AND MATERIALS 652 (7th ed. 1992).

[101]Eggleston Principle took its name from the Company Law Advisory Committee (the Eggleston Committee), which conducted a review of the situation of investor protection offered by the then existing takeover law. *See* Company Law Advisory Committee, Second Interim Report: Disclosure of Substantial Shareholdings and Takeover Bids 6 (Canberra: AGPS, 1969), *available at* http://www.takeovers.gov.au/display.acp?ContentID=494. According to this principle:

> [i]f a natural person or corporation wishes to acquire control of a company by making a general offer to acquire all the shares, or a proportion sufficient to enable him to exercise voting control, limitations should be placed on his freedom of action so far as is necessary to ensure:
>
> (i) that his identity is known to the shareholders and directors;
>
> (ii) that the shareholders and directors have a reasonable time in which to consider the proposal;
>
> (iii) that the offeror is required to give such information as is necessary to enable the shareholders to form a judgment on the merits of the proposal and, in particular, where the offeror offers shares or interests in a corporation, that the kind of information which would ordinarily be provided in a prospectus is furnished to the offeree shareholders; [and]
>
> (iv) that so far as is practicable, each shareholder should have an equal

application of Sir Richard Eggleston's equity jurisprudence."[102]

The U.S. provides another good example. A cash tender offeror could operate in virtual secrecy like a corporate raider in the pre-*Williams Act* era because the law did not require that "[a cash tender offeror] disclose his identity, the source of his funds, who his associate were, or what he intended to do if he gained control of the corporation."[103] The *Williams Act* was designed to protect investors by requiring sufficient information to be provided to enable them to make an informed decision with respect to a tender offer.[104] It is the purpose of the *Williams Act* that the target company management adopt appropriate defensive tactics to increase the value to target shareholders.[105]

The objective of shareholder protection, however, may conflict with the economic objectives of efficiency in resource allocation to the extent that the rule would render the hostile takeover more difficult and thus diminish the contestability of takeovers. The substantial costs associated with information disclosure and tender offer rules, which are designed to protect investors, may effectively deter many takeovers that otherwise would have been launched.[106] Furthermore, it is widely recognized that the target's management has the incentive to abuse defensive tactics with respect to hostile takeovers for the purpose of entrenchment.[107] Some takeover defenses, which were originally designed as a means to protect target shareholders from raiders, have been found to be frequently misused by the target's management. For example, the target's management would use defensive measures to thwart a hostile takeover that would injure their interests, regardless of whether the takeover would be beneficial to the shareholders,[108] resulting in the diminished contestability of takeovers. This problem has been at the heart of the discussion of takeover law and

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opportunity to participate in the benefits offered.

[102]Tony Greenwood, *In addition to Justin Mannolini*, 11 AUSTL. J. CORP. L. 308, 310 (2000).

[103]S. REP. NO. 90-550, at 2 (1967).

[104]*Id.*

[105]JENNINGS ET AL., *supra* note 100, at 655

[106]*See, e.g.*, Justin Mannolini, *Convergence or Divergence: Is there a Role for the Eggleston Principles in a Global M&A Environment?*, 24 SYDNEY L. REV. 336 (2002) (arguing that the protection of minority shareholders as advocated by Eggleston Principle is a "luxury" of economically inefficient, albeit admirably egalitarian, rules).

[107]Easterbrook & Fischel, *supra* note 71, at 1194. *See also* Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1029 (1982); Gilson, *supra* note 72, at 819.

[108]*See, e.g.*, Lucian Arye Bebchuk & Allen Ferrel, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999).

received a wide range of practical and academic attention. Accordingly, this article also addresses this issue.

IV. TAKEOVER: BIDDER AND THE TARGET'S SHAREHOLDERS

When a bidder proposes a tender offer, takeover law focuses on the protection of the target shareholders from unjust treatment in hostile takeovers. This protection is in the form of requiring information disclosure and specifying certain other aspects of tender offers.

A. *Disclosure of Substantial Shareholdings*

To protect target shareholders from corporate raiders, the takeover laws of most jurisdictions generally require adequate information disclosure so that shareholders can make informed decisions after thorough deliberation. Of particular relevance to the contestability is the disclosure of the identity of persons or groups with substantial holdings, which provides the market with an early warning of possible takeovers.[109] In China, the Securities Law provides for broad disclosure with respect to substantial shareholders.[110] When an investor comes to hold five percent of the shares issued by a listed company, the investor must disclose his or her position.[111] This disclosure must occur within three business days from the date when such shareholding occurs by submitting a written report to the CSRC and the stock exchange.[112] During this period, the investor may not continue to purchase or sell shares of the listed company.[113] Thus, the investor is prohibited from changing his or her ownership position until the market is informed. The Measures for Disclosure further expands substantial shareholders' duty to disclose to share controllers, and investors acting in concert, something equivalent to the notion of the beneficial investor in the U.S.[114]

In the U.S., Section 13(d) of the Securities Exchange Act imposes a similar disclosure requirement on persons within ten days of the date that they acquire beneficial ownership of more than five percent of a public

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[109]JENNINGS ET AL., *supra* note 100, at 652.

[110]*See* Securities Law, *supra* note 51.

[111]*Id.* at art. 79(1).

[112]*Id.*

[113]*Id.* art. 79(2).

[114]Measures for Disclosure, *supra* note 53, arts. 6-9. For the concept of beneficial ownership in the U.S., see 17 C.F.R. § 240.13d-3 (2004).

company.[115] Much like China, the U.S. does not permit substantial shareholders to continue to purchase shares during this period before making the announcement.[116] If, however, there is a material change in the holdings, including an acquisition or disposition of one percent of outstanding shares in the said company, the owner must promptly file an amendment.[117]

In Australia, if a shareholder begins to have, or ceases to have a relevant interest in five percent or more of the all shares in a company or scheme, that shareholder is deemed to have acquired a substantial holding in that company or scheme.[118] This is relevant because once this occurs, that shareholder must disclose the information within two business days after the shareholder first becomes aware of this information.[119] Further, where there is a movement of at least one percent in the substantial shareholders' holdings, this is required to be disclosed within two business days.[120] Thus Australia requires disclosure in much the same fashion as both China and the United States.

Clearly, the threshold for substantial shareholdings and the time for disclosure would exert significant influence on the contestability of takeovers.[121] The lower the threshold, the more protection the shareholder will get; therefore, the resulting takeover would be more difficult. Generally, the bidder needs to accumulate a certain number of shares, always called a toehold, before initiating a takeover.[122] If the bidder is required to disclose his or her holdings too early, the market would react to raise the share price and the takeover would be more expensive.[123] As Fischel stated:

> [o]utsiders are not generally privy to inside information about a potential target. A decision to tender only occurs after an offeror determines that the target will be more profitable in its

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[115] 15 U.S.C. § 78m(d) (2000).

[116] 17 C.F.R. § 240.13d-1(e)(2)(ii) (2004).

[117] *Id.* § 240.13d-2(a).

[118] Corporations Act, 2001, sec. 9 (Austl.).

[119] *Id.* sec. 671B(6).

[120] *Id.* sec. 671B(1)(b).

[121] RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 898 (2d ed. 1995) (pointing out that "the disclosure obligation imposed by 13(d) [of the Securities Exchange Act 1934] has particular significance for a would-be acquirer").

[122] *See, e.g.*, Guido A. Ferrarini, *Share Ownership, Takeover Law and the Contestability of Corporate Control*, at 4, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265429 (citations omitted).

[123] *Id.*

> control and that a tender offer is likely succeed. These decisions involve research costs. The incentive to produce this information is the expected gain from the appreciation of the offeror's equity investment after obtaining control. Any legal constraint that limits the ability of owners of privately produced information to realize its exchange value will discourage devoting resources to produce new information.[124]

Not surprisingly, if the bidder's incentive is decreased, there might be fewer takeovers.

Therefore, a trade-off must be set between the protection of shareholders and the contestability of corporate control by choosing the appropriate threshold and disclosure time. This balance should be determined on the basis of the local situation. Thus, it might be the adjustment of the threshold and disclosure time according to the changing commercial environment. In China, for example, the 1993 Provisional Regulations require a substantial shareholder to disclose the change in the holding of at least two percent of the outstanding shares.[125] In order to encourage takeovers, this threshold has been raised to five percent in the Securities Law as previously discussed.[126] The increase from two percent to five percent may be arbitrary and seems to have an impressionistic flavor; however, in the absence of reliable empirical data, it is difficult to judge whether the figures are incapable of balancing shareholder protection with the contestability of takeovers. At the very least, China is now consistent with the international norm.

B. *Tender Offer Rules*

Takeover laws also provide a safeguard for target shareholders to prevent coercive tender offers, including reasonable time to consider the proposal and equal opportunity to participate.[127] In China, the bidder must inform the market of the terms of the offer,[128] and the offer should be open for a minimum time to avoid shareholders making a decision hastily.[129] If

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[124]Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 13 (1978).

[125]Provisional Regulations, *supra* note 49, art. 47.

[126]*See supra* notes 110-13 and accompanying text.

[127]JENNINGS ET AL., *supra* note 100, at 654-55.

[128]Measures for Regulating Takeovers, *supra* note 2, art. 26.

[129]*Id.* art. 36 (providing that the effective period of the offer must be no less than thirty days and no more than sixty days, except where there is a contested offer).

the bidder wants to vary the terms of the offer, the approval of the CSRC is required.[130] Further, the target's shareholders can now withdraw their acceptance.[131] Before the tender offer is announced, the bidder is prohibited from purchasing any target shares.[132] Most other jurisdictions have similar provisions.[133]

China's takeover law attempts to ensure the equal treatment of all target shareholders and pays particular attention to minority shareholders after takeovers. A mandatory bid requirement was incorporated into the Securities Law to achieve this goal.[134] When an investor comes to hold thirty percent of the issued shares of a listed company and wants to continue purchasing such shares, that investor must issue an offer to all the shareholders of the listed company, unless exempted by the CSRC.[135] Unfortunately, the situations where exemptions would be granted were not clarified in the Securities Law,[136] which results in confusion. To solve this problem, the Measures for Regulating Takeovers devotes an entire chapter to explain the conditions and steps required in applying for an exemption.[137] Measures for Regulating Takeovers requires the tender offer price for quoted shares to be either the highest price paid by the acquirer for its shares during the six months prior to the offer or ninety percent of the arithmetic average of the daily weighted average market price of such shares during a thirty-day trading period preceding the announcement of the offer, whichever is greater in value.[138] If the tender offer expires and the acquirer has gotten no less than ninety percent of the total outstanding shares of the target company, the remaining shareholders have the right to

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[130]*See* Securities Law, *supra* note 51, art. 84; Measures for Regulating Takeovers, *supra* note 2, art. 37.

[131]Securities Law, *supra* note 51, art. 41.

[132]*Id.* art. 23.

[133]*E.g.*, in the U.S., see 15 U.S.C. § 78n(d)-(e) (2000); 17 C.F.R. § 240.14e-1 (2004). In Australia, see Corporations Act, 2001, sec. 624(1) (duration of the offer), sec. 635 (steps in market bid), sec. 636 (content of bidders' statement), sec. 652 (withdraw of an offer).

[134]Securities Law, *supra* note 51, art. 81.

[135]*Id.* This mandatory tender offer obligation will also be triggered when an investor enters into a private agreement to acquire more than thirty percent of the issued shares. In a recent case, Dikang Konggu was forced to make a tender offer because it has acquired more than thirty percent of the state shares of the Chengshang Group by a private agreement. *See* Jun Li, *The Transfer of State Shares of Chengshang Group Triggers Mandatory Bid*, GUOJI JINGRONG BAO [INT'L FIN. NEWS], Apr. 15, 2003, at 7.

[136]Fu & Shao, *supra* note 10, at 268.

[137]Measures for Regulating Takeovers, *supra* note 2, ch. 4. Such conditions that would qualify for an exemption would include those where thirty percent of the holdings by one investor were caused by a new issuance of shares in accordance with a shareholder resolution or a share transfer due to a court order. *See id.* art. 49.

[138]*Id.* art. 34.

enforce the sale of their shares on the same terms as those in the offer.[139] In this way, the remaining minority shareholders can be protected from a freeze-out merger on terms less favorable than those of the offer.

Australia and the UK provide similar protective mechanisms to target shareholders. China's mandatory bid rule is almost identical to that in the UK as stated in the City Code on Takeovers and Mergers.[140] In Australia, acquiring more than a threshold of twenty percent of voting power in a company is prohibited, subject to a number of exceptions, including the making of a full takeover offer.[141] In contrast, the U.S. does not require a thirty percent shareholder to make an offer,[142] and the Williams Act provides less protection for remaining shareholders in a freeze-out merger as in China. Thus, minority shareholders could be paid consideration with a value lower than the bid price in an immediate takeover.[143]

The mandatory bid rule could provide a great degree of shareholder protection by ensuring that the control premium is shared amongst all shareholders. (This is seemingly in line with the principle of equal treatment.) Thus, China's takeover law seems more attractive than its American counterpart from the target shareholders' point of view. This, however, comes at the expense of the contestability of takeovers because it would increase the cost of takeovers and scare off some potential bidders.[144]

This concern could be better met by fine-tuning the mandatory bid rule rather than abandoning it in order to keep a balance between the two conflicting goals. In particular, the bid price and the triggering threshold

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[139]Securities Law, *supra* note 51, art. 87.

[140]City Code on Takeovers and Mergers, Rule 9, *available at* http://www.thetakeoverpanel.org.uk [hereinafter City Code]. The city code will be discussed in detail in Part V.B.2 of this article.

[141]Corporations Act, 2001, secs. 606, 611, 616 (Austl.). The Australian takeover provisions are different from the mandatory bid rule. These provisions are in effect more stringent than the mandatory bid rule because the mandatory bid rule allows for control to pass prior to a general offer via "pre-bid agreements or understandings between bidders and target shareholders" thus reducing the costs of takeovers. *See* CLERP Paper No.4: Proposals for Reform-Takeovers, para 4.1, *available at* http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=284.

[142]15 U.S.C. §§ 78m(d)-(f), 78n(d)-8 (2000).

[143]Lucian Arye Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, *in* KNIGHTS, RAIDERS, AND TARGETS, THE IMPACT OF THE HOSTILE TAKEOVER 371, 374 (John C. Coffee, Jr. et al. eds., 1988) (citations omitted). *See also* Thompson, *supra* note 1, at 326 (stating that "it is possible for a bidder to purchase a control block from a private party without making an offer to other shareholders and probably without any sharing of a control premium paid to the departing control group") (footnotes omitted).

[144]Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. OF ECON. 957, 960 (1994).

set in the rule could greatly influence the practical outcome of the rule. Even though it may be difficult to set the numbers to fit local situations (as in the information disclosure system), the inherent flexibility of the mandatory bid rule could be a valuable tool to meet the policy goals. In China, for example, the Provisional Regulations provide that the bid price is the greater of either the highest price paid by the offeror in the twelve months preceding disclosure of the bid, or the average market price during a thirty day trading period prior to the bid.[145] In comparison, the new Measures for Regulating Takeovers reduce the bid price.[146] This suggests that China intends to encourage takeovers by mitigating the mandatory bid rule.

V. TAKEOVER DEFENSES: TARGET SHAREHOLDERS AND MANAGEMENT

A. *Takeover Defenses in China: Regulations and Problems*

A recent, significant development in China's takeover law is the introduction of rules on takeover defenses. Before the promulgation of the Measures for Regulating Takeovers in 2002, the law had been silent on this crucial and controversial area.[147] While the CSRC should be commended for its efforts to fill this legal gap, it seems to have fallen short of its goal. Under Article 33 of the Measures for Regulating Takeovers,

> [t]he measures taken by the directors, supervisors and other senior officials of the target company in response to the takeover activities at issue, shall not damage the lawful interests of the target company and its shareholders.
> After the acquirer makes [a] takeover announcement, the board of directors of the target company can only continue to execute the existing contracts or the resolutions previously made by the shareholder general meeting, and shall not propose the following measures,
> (1) issue new shares;
> (2) issue convertible company bonds;
> (3) buy back its own issued shares;
> (4) modify the company constitution;

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[145]Provisional Regulations, *supra* note 49, art. 48.

[146]Measures for Regulating Takeovers, *supra* note 2, art. 34.

[147]Fu & Shao, *supra* note 10, at 270.

> (5) enter 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) dispose of or purchase material assets, adjust the principal business of the company, save in exceptional situations where the company adjusts the business or restructures the capital when faced with serious financial difficulty.[148]

The first part of Article 33 makes it clear that not damaging "the lawful interests of the target company and its shareholders"[149] is the criterion for the target company's management to decide on the use of available anti-takeover defenses.[150] There is nothing improper about the values embodied in this guideline, namely shareholder protection. This criterion, however, is more like a political announcement than a mature legal provision and is obviously too vague and simplistic to provide any concrete guidelines in practice. The lack of workability is exacerbated by the fact that the legal theory and doctrine about director's duties in China are far from developed. The duty of care, for example, is virtually absent from the Company Law, and the duty of loyalty is far too primitive and difficult to apply.[151] Moreover, the courts in China are widely believed to be incompetent in dealing with the issue of directors' duties and, thus, unable to offer appropriate protection for shareholders in the event that directors violate their duties.[152] Therefore, without sound support from the general provisions regarding directorial duties, this guideline is of little practical value.

It seems that the drafters may have already realized this problem and have introduced the second part to remedy it. Unfortunately, the attempted remedy is inappropriate. In order to curb the discretionary power of the target's management, the second part just lists six types of commonly-used defensive tactics that the target's management cannot employ under any circumstance.[153] It is starkly inconsistent with the guideline set out in the

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[148]Measures for Regulating Takeovers, *supra* note 2, art. 33.

[149]*Id.*

[150]*Id.*

[151]KAIPING ZHANG, YINGMEI GONGSI DONGSHI ZHIDU YANJIU [RESEARCH ON DIRECTORS DUTY IN ANGLO-AMERICAN CORPORATIONS] 313 (1998).

[152]The Chinese judges lack necessary knowledge and experience to deal with complicated company law cases. *See, e.g.*, *Zhongguo Sifa Gaige Yanjiu [Study on Judicial Reform in China]* 23-24 (Shigui Tan ed. 1st ed. 2000).

[153]Measures for Regulating Takeovers, *supra* note 2, art. 33.

first part. The principle established in the first part is that any defense could be used as long as it does "not damage the lawful interests of the target company and its shareholders."[154] The second part, however, provides that the listed defenses cannot be used in any way, irrespective of whether or not the defenses would "damage the lawful interests of the target company and its shareholders."[155]

The first problem is illustrated by the third defense enumerated in the article, a company's repurchase of its own issued shares.[156] In fact, the Company Law has generally proscribed the practice of repurchase.[157] Under Article 149 of the Company Law, a company may not purchase its own shares except where shares needs to be cancelled for the purpose of reducing its capital or where the company merges with another company that holds its shares.[158] Repurchase has already been prevented from being used as a defensive tactic in the context of takeovers under the Company Law and there is no need to repeat it again under the Measures for Regulating Takeovers.

Second, the exception clause involved in the fifth provision, namely, "for the purpose of conducting the ordinary business of the company,"[159] renders the prohibition of the fifth defense virtually meaningless. According to this provision, it is perfectly acceptable for directors to enter into material contracts when confronted with takeovers, so long as they are "conducting the ordinary business of the company."[160] This provision seems reasonable, yet it is highly likely that in practice this provision would not function as expected. This is because the directors can tactically enter into contracts to serve mixed purposes, including the legitimate purpose of conducting ordinary business, and the illegitimate purpose of thwarting a takeover. If the contract entered into objectively serves some permissible purpose, then it will be free from attack even if the concealed purpose or the factual effect of it is to ward off the takeover. It is extremely difficult to make a judgment as to the appropriateness of the contract where it serves both legitimate and illegitimate purposes. To determine the real purpose for which an action has been taken, one needs to delimit the primary or substantial purpose from the competing purposes. If the substantial

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[154] *Id.*

[155] *Id.*

[156] *Id.* art. 33(3).

[157] Company Law, *supra* note 50, art. 149.

[158] *Id.*

[159] Measures for Regulating Takeovers, *supra* note 2, art. 33.

[160] *Id.*

purpose is found illegal, then the action would be invalid.[161] Nevertheless, this process of determining the primary purpose is dependant on proving the motives of the directors, and unfortunately it is just as difficult to ascertain the motives.[162] In most cases, this evidentiary obstacle would be insurmountable because one must prove that directors acted for an improper purpose and this improper purpose was the substantial purpose.

Thus, it is very difficult, and perhaps impossible in China (given the highly questionable competence of the courts)[163] to distinguish the genuine purpose for conducting ordinary business from the false one presumably used as a cover for impermissible purposes. In fact, even in the West, where the courts are thought to be quite experienced, this has posed a serious problem.[164] If the directors can readily frustrate an unsolicited takeover in the guise of "conducting the ordinary business,"[165] subsection (5) of Article 33 is of little practical value to limit the ability of directors to use this defensive tactic.

Finally, and most importantly, this solution of simply singling out certain types of defenses as prohibited practice appears insensible, baseless in character, and prone to yield perverse results. There seems to be no good reason why the drafters chose only those six defensive tactics at the expense of many others. As such, the selection of the six defensive tactics was essentially arbitrary. Furthermore, there are a wide range of defensive tactics available in practice, such as poison pills, share repellent provisions, golden parachutes, greenmail, etc.,[166]and it is reasonable to expect that new types of defensive tactics will emerge in the future.[167] Obviously, the six

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[161]In an Australian case, *Mills v. Mills*, (1938) 60 CLR 150,186, Judge Dixon held that except for some ulterior or illegitimate object, the power would not have been exercised, that which has been attempted as an ostensible exercise of the power will be void, notwithstanding that the directors may incidentally bring about a result which is within the purpose of the power and which they consider desirable.

[162]This corresponds to the problem around the proportionality test in the U.S. *See infra* notes 254-56 and accompanying text.

[163]*See supra* note 152 and accompanying text.

[164]James Mayanja, *Reforming Australia's Takeover Defence Laws: What Role for Target Directors? A Reply and Extension*, 10 AUSTL. J. CORP. L. 162, 173 (1999) (arguing that "it will ordinarily be hard to challenge transactions entered into by directors to prevent a change in the control of a company which serve mixed purpose").

[165]Measures for Regulating Takeovers, *supra* note 2, art. 33.

[166]For a description of various anti-takeover defenses, see DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS ch. III (2d ed. 1987) (summarizing many more than six types of anti-takeover defenses).

[167]Poison pills, for example, have evolved. Under a poison pill plan, the company issues to all existing shareholders new rights that will entitle them to purchase additional shares, usually at half price, triggered by the unwanted takeover activities. This will result in a dilution effect,

types of defenses proscribed by the second part of Article 33 are only part of all defenses available and it is clear that the standard for the selection of those six banned types of defenses is not the principle advocated by the first part of the article.[168]

It is improper to *ex ante* selectively prohibit certain types of defenses, without regard to the specific context in which they are used. The appropriateness of any given defense must be judged in specific situations and the conclusion would vary depending on those situations. Interestingly enough, after comparing Article 33 and Rule 21 of the City Code,[169] we find that the six types of defenses listed in Article 33 are coincidently mentioned in the latter.[170] This fact suggests that the most likely reason why the six defenses are chosen is that the drafters have simply copied Rule 21 of the City Code on Takeovers and Mergers without any serious consideration.

Consequently, the list in Article 33 is doomed to be both over-inclusive and under-inclusive. On the one hand, it is over-inclusive in that it is hard to argue that the six listed defenses would damage the lawful interests of the target company and its shareholders in any situations and thus should be prohibited altogether. Rather, these defenses could be effectively used for the benefit of the company and its shareholders in the face of a truly undesirable takeover. The blanket prohibition of these defenses as Article 33 stipulates would impede management's ability to take suitable steps to protect the target shareholders from company raiders. On the other hand, it is under-inclusive in that there is little doubt that any defensive tactic is likely to be abused, at least in theory. It would be dangerous to think that all the defenses other than the six listed types in Article 33 would not damage the lawful interests of the target company and its shareholders in any circumstance. In fact, the second part has done

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which in turn usually causes a high enough price to deter the bid. The traditional poison pill could be redeemed by the target board. Recently, two new variations of poison pill have been invented, including the so-called "dead hand" poison pill and the "slow hand" poison pill. A dead hand poison pill could only be redeemed by the board that instituted the pill, and a slow hand poison pill could not be redeemed in the six months following the takeover by anybody, including the directors who created it themselves. These two new poison pills were intended to address the issue that if the current board of the target company is replaced by a successful proxy fight the hold-over board could redeem the traditional poison pill and thus destroy the defense. Both of these pills, however, were struck down by the Delaware courts, respectively. *See* Quickturn Design Sys. Inc. v. Shapiro, 721 A.2d 1281, 1283 (Del. 1998); Carmody v. Toll Bros., 723 A.2d 1180, 1182 (Del. Ch. 1998).

[168]Measures for Regulating Takeovers, *supra* note 2, art. 33; City Code, *supra* note 140, Rule 21.

[169]*See infra* Part V.B.2.

[170]Measures for Regulating Takeovers, *supra* note 2, art. 33.

nothing to provide any further rules with respect to the use of other defensive tactics. Thus, the legislative intent to prevent target management from abusing defenses can hardly be realized under Article 33 because if management intends to entrench themselves, they could still effectively use other non-prohibited defenses. At the very least, the target's management can safely adopt other defenses, without violation of the second part of the article. This is not perfectly secure because the defense could possibly be caught under the first part of the article if it clearly damaged the target company,[171] and the second part of Article 33 does not expressly guarantee that other defenses could be used freely.[172] Thus, the question about the use of other defenses is in fact left unaddressed in the second part. Therefore, the solution adopted by Article 33 seems too rigid to accommodate the complex and rapidly changing commercial situations where defensive tactics could emerge and operate.

B. *Some Overseas Experience*

1. United States (Delaware Law)

In the U.S. takeover defense regime, as represented by Delaware law, the directors of target corporations are empowered to institute a wide variety of defensive measures in response to hostile takeovers.[173] Obviously, target management enjoys substantial discretionary power. In order to prevent target management from abusing their power to take defensive measures (for the sole purpose of entrenchment), U.S. takeover law imposes levels of judicial review depending on the perceived possibility of management opportunism.[174] When target management adopts a defensive measure against a hostile bid, Delaware law applies the "modified business judgment rule" under which the directors are required "to show that after a 'good faith and reasonable investigation,' they saw a danger to corporate policy and effectiveness."[175] In 1985, the Delaware Supreme Court decided a leading case regarding takeover defenses: *Unocal Corp. v. Mesa Petroleum Co.*[176] In this case, the court made several important developments concerning the judicial review of target

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[171] *Id.*

[172] *Id.*

[173] *See* ROBERT C. CLARK, CORPORATE LAW 581-82 (1986) (offering an explanation of various defensive measures).

[174] Kirchner & Painter, *supra* note 1, at 452.

[175] *Id.* (quoting Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964)).

[176] 493 A.2d 946 (Del. 1985).

management's use of anti-takeover defenses. The court held that the board of the target corporation "has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders."[177] Having established this general principle, the court then proceeded to articulate the directors' duties in the context of takeovers. According to this case, the defendants, namely the target company directors, are now required to show (1) "that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership," and (2) that "it [the defensive measure] must be reasonable in relation to threat posed."[178] It is worth noting here that the defendant, not the plaintiff, bears the burden of proof.[179] This makes judicial review act as a deterrent to abusive use of takeover defenses.[180]

Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., further developed judicial review concerning the duties of target management when using defensive measures.[181] Under *Revlon*, directors' duties will change once the board reasonably believes that the sale of the company is

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[177]*Id.* at 954.

[178]*Id.* at 955 (citations omitted). The court went on further to discuss the relational requirement, stating:

> This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders(i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of the securities being offered in the exchange . . . . While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.

Id. at 955-56 (footnotes omitted). *See also* John H. Farrer, *Business Judgment and Defensive Tactics in Hostile Takeover Bids*, 15 CAN. BUS. L.J. 15, 22 (1989) (describing *Unocal*).

[179]Farrer, *supra* note 178, at 22.

[180]Under the traditional business judgment rule, the burden of proof lies on the plaintiff unless there is a conflict of interest in the case. *See* Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Scared Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 277-78 (2001). Before 1985, however, director-instituted defensive measures did not constitute express conflict of interests and thus the courts required the plaintiff to present evidence of lack of sufficient investigation, lack of good faith, and so on. This way is called the "deferential review of the traditional business judgment rule." *See* Parter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980). *Accord* Stotland v. GAF Corp., No. 6876, 1983 Del. Ch. LEXIS 477 (Del. Ch. Sept. 1, 1983). In *Unocal*, the court stated that there exists an "omnipresent spectre" of conflict of interest in the use of takeover defenses, even though this conflict falls short of the express conflict in the traditional cases, such as a self-dealing transaction; based on this conflict, the court switched the burden of proof to the defendants. *Unocal*, 493 A.2d at 954-55.

[181]506 A.2d 173 (Del. 1985).

inevitable or the board takes steps to put the company up for sale.[182] Upon this triggering situation, the directors must discharge their duties by obtaining the highest price for shareholders, rather than maintaining the corporate enterprise, and cannot adopt a defense for the purpose of giving absolute priority to a non-shareholder constituency.[183]

Thus, the defenses permitted by *Unocal* could be a breach of the directors' fiduciary duty if the company is in the same situation as *Revlon*. Two subsequent cases, *Paramount Communications, Inc.. v. Time, Inc.*[184] and *Paramount Communications, Inc. v. QVC Network Inc.*,[185] offered some guide to distinguish defensive transactions that put a company into a *Revlon* situation from transactions that do not. If a transaction contemplates a change in control of the target company, for example, by selling a control block of the target's stock to a single person or corporation, then the *Revlon* duty would be imposed on the target's management,[186] otherwise only the *Unocal* duty would apply.[187] In short, under Delaware law, the use of defensive measures is a matter within the business discretion of the target's directors and officers.

2. United Kingdom

In the UK, the conduct of target management in the context of takeovers is regulated by both the common law and a voluntary code of conduct known as the City Code on Takeovers and Mergers (the City Code).[188] Under the common law in the UK, the directors of the target company are subject to equitable principles of fiduciary law and are required to act bona fide in the interests of the company when using defensive tactics.[189] This fiduciary-duty-based system is very similar to that of the U.S., even though there may be some differences in the contents or judicial interpretations of the amorphous notion of fiduciary duty.[190] Of

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[182] *Id.* at 182.

[183] *Id.* Other states, however, allow the target directors to consider the interests of non-shareholder constituencies in the context of takeovers. Furthermore, "Connecticut . . . requires directors to consider non-shareholder constituencies in change of control transactions." *See* Kirchner & Painter, *supra* note 1, at 453 n.7.

[184] 571 A.2d 1140 (Del. 1989).

[185] 637 A.2d 34 (Del. 1994).

[186] Kirchner & Painter, *supra* note 1, at 453 n.6.

[187] *Id.*

[188] Farrer, *supra* note 178, at 27; City Code, *supra* note 140.

[189] Farrer, *supra* note 178, at 27-31.

[190] For a relatively detailed comparison of the directors' duties in the context of takeovers in several commonwealth countries, see, e.g., Farrer, *supra* note 178; Mayanja, *supra* note 164.

more interest, however, is the new method in which the City Code puts a system of checks and balances on the use of defenses by the target's management.

The framework regulating the use of defenses by the target directors in the City Code exhibits a sharp contrast with that of U.S. law. The City Code is a voluntary agreement issued and administered by the Panel on Takeovers and Mergers in the City of London since 1968.[191] The Panel is a self-regulatory organization in charge of takeover and merger transactions.[192] Although the City Code does not have the force of law, it has gained tremendous influence, because it "represents the collective opinion of those professionally involved in the field of takeovers as to good business standards and as to how fairness to shareholders can be achieved."[193] Furthermore, the City Code's influence is based on the fact that it has been well enforced by a powerful self-regulating organization, the Panel.[194]

Under the strict "neutrality rule" in Principle 7 of the City Code, it is forbidden for the target's management to adopt "any action . . ., which could effectively result in any bona fide offer being frustrated or in the shareholders of the offeree company being denied the opportunity to decide on its merits."[195] Further, the City Code makes it clear that once an offer has been made or appears to be imminent, all defensive transactions which could frustrate the bid must be approved by shareholders at the general meeting.[196] Thus, in the City Code, the shareholders, rather than the directors, have the final say with respect to the employment of defensive measures.

3. Australia

Australia has a new mechanism to resolve issues about the use of defensive measures by the target's management. It is similar to the U.S. model to the extent that the target directors can exercise their discretion to

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[191]*See* City Code, *supra* note 140.

[192]*See* Tunde I. Ogowewo, *Is Contract the Juridical Basis of the Takeover Panel?* 12 J. INT'L BANKING L. 15 (1997) (concluding that the Takeovers Panel relies on a self-regulatory system, and has neither legislative backing nor a contractual basis).

[193]City Code, *supra* note 140, Introduction, § 1, para. (a).

[194]If a person or business who is authorized to conduct investment activity within the UK fails to comply with the City Code, the Panel may sanction that person or business by withdrawing its authorization. *See id.* para. 1(c). The deliberations of the panel, however, may be subject to judicial review by the court. *See* R. v. Takeover Panel, ex. p. Datafin PLC, [1987] 1 All E.R. 564.

[195]City Code, *supra* note 140, Principle 7.

[196]*Id.* Rule 21.1.

adopt defenses without the intervention of the shareholders in advance, subject to the equitable principles of fiduciary law.[197] The Australian model differs from the U.S. in that the *ex post* judgment about the directors' fiduciary duty is left to a special panel, not the courts.[198]

This panel, called the Takeovers Panel, received considerably expanded powers through the federal government's Corporate Law and Economic Reform (CLERP) legislation in March 2000.[199] The Takeovers Panel replaces the courts as the main forum for resolving disputes arising from a takeover bid during the bid period.[200] The Australian Securities and Investment Commission (ASIC) can commence court proceedings before the end of the bid period along with a select group of other governmental entities.[201] After the bid period, however, the courts resume jurisdiction over disputes involving takeovers.[202]

The Takeovers Panel is authorized to "declare circumstances to be unacceptable circumstances whether or not the circumstances constitute a contravention of a provision of this Act."[203] Anyone whose interests are affected by the circumstances, such as bidders or targets, is eligible to apply for such a declaration.[204] This declaration of unacceptable circumstances can only be made

> if it appears to the Panel that the circumstances are: unacceptable having regard to the effect of the circumstances on: (1) the control, or potential control, of the company or another company; or (2) the acquisition, or proposed acquisition, by a person of a substantial interest in the company or another company.[205]

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[197]Mayanja, *supra* note 164.

[198]Erin Walsh, *Judging the Takeovers Panel*, 20 CO. & SEC. L.J. 435, 435-36 (2002).

[199]*See, e.g.*, ROMAN TOMASIC ET AL., CORPORATIONS LAW IN AUSTRALIA 719 (2d ed. 2002). "The 1999 *CLERP Act* has significantly increased the powers of the Panel in the takeover process, and by doing so, downgraded the role of the court in dealing with takeover disputes." *See also* SUSAN WOODWARD ET AL., CORPORATIONS LAW IN PRINCIPLE 407 (5th ed. 2001) (examining the Takeovers Panel after the CLERP legislation).

[200]Walsh, *supra* note 198, at 435.

[201]Corporations Act, 2001, sec. 659B(1) (Austl.).

[202]Walsh, *supra* note 198, at 437.

[203]Corporations Act, 2001, sec. 657A (Austl.).

[204]*Id.* sec. 657C.

[205]*Id.* sec. 657A(2)(a).

Further, "the declaration must be in writing and published,"[206] and "[a]s soon as practicable, the Panel must give each person to whom declaration relates: a copy of the declaration; and a written statement of the Panel's reasons for making the declaration."[207] The way of dealing with the dispute is very flexible in the sense that the panel is not required "to perform a function, or exercise a power, in a particular way in a particular case."[208] If the Takeovers Panel has made a declaration of unacceptable circumstances, it can then make orders.[209] A court can order compliance with an order of the Takeovers Panel and thus strengthen its credibility.[210]

This institutional change was developed to prevent target management from using the courts as a defensive tactic during the takeover to delay a bid, as judgment via the courts are always costly and time consuming.[211] It is hoped that a specialist body would be better equipped and more efficient to handle the complex disputes regarding takeovers than the courts. The Takeovers Panel is comprised of practitioners in business and law and some judges and academics who possess notable expertise in the relevant field.[212] Further, the less burdensome working procedure of the Takeovers Panel facilitates resolving takeover disputes more quickly. Thus, even if applications are brought before the Takeovers Panel for the purpose of tactical maneuvering, the Takeovers Panel can address such tactics more effectively and discourage tactical litigation.[213] Three years have passed since this new regime was established, and it now seems that the Takeovers Panel did not belie legislative expectations and has developed a positive reputation.[214]

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[206] *Id.* sec. 657A(5).

[207] Corporations Act, 2001, sec. 657A(6) (Austl.).

[208] *Id.* sec. 657A(7).

[209] *Id.* sec. 657D(1).

[210] *Id.* sec. 657(G)(1).

[211] WOODWARD ET AL., *supra* note 199, at 407; Roman Tomasic & Brendan Pentony, *Resisting to the Last Shareholders' Dollar: Takeover Litigation—A Tactical Device*, 1(2) AUSTL. J. CORP. L. 154, 155 (1992) (arguing that litigants use litigation to "buy time in which to assemble a defence and rally the shareholders").

[212] Walsh, *supra* note 198, at 438.

[213] *Id.*

[214] *See, e.g.*, Brett Clegg, *Takeovers Panel Earns its Stripes*, AUSTL. FIN. REV. S-3 (Feb. 27, 2002); Walsh, *supra* note 198, at 435 (stating that "[t]he Takeovers Panel has almost universally been dubbed a success").

C. *Reform Proposals*

The Chinese legislative attitude towards defensive tactics, as shown in Article 33 of the Measures for Regulating Takeovers, seems to discourage the use of defenses to avoid opportunism.[215] This orientation is desirable because at the present stage of economic development in China, the benefits of takeover activities are urgently needed; thus, the law should ensure the contestability of takeovers.[216] Target directors might misuse the defenses, as there are conflicts of interest inherit in them. Moreover, such abuses would inhibit takeovers, thus depriving people of various benefits such as efficient allocation of scarce resources, a mechanism of monitoring corporate management, etc.[217] This does not suggest, however, that China needs to wholly abandon the use of such defenses, as the Measures for Regulating Takeovers implies.[218] Easterbrook and Fischel have contended that management should act passively in response to takeovers.[219] Notably, this pure passivity rule has received little support from the U.S. courts or legislators.[220]

Rather, the goal is to design an effective mechanism to eliminate the abuse of defenses but at the same time preserve the use of defenses for proper purposes. This is based on two main reasons. First, the debate about the value of takeovers is unsettled. Even though it is submitted that China should encourage takeover activities, China cannot push this inclination to an unlimited extreme without consideration of the potential harms associated with takeovers. Second, and more visibly, the defenses could be properly used by target management for the benefits of the shareholders. It is important to note that the shareholder protection principle presented in this article has two aspects: (1) protection of shareholders from management opportunism, and (2) protection of shareholders from corporate raiders.[221] Target management could protect shareholders by using anti-takeover defenses to thwart some genuinely undesirable takeovers. Further, in a contested takeover some defenses could be employed to instigate an auction, which would get the

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[215] *See supra* Part V.A.

[216] *See supra* Part III.A.

[217] *See supra* Part III.A.

[218] *See* Measure for Regulating Takeovers, *supra* note 2.

[219] Easterbrook & Fischel, *supra* note 71, at 1164.

[220] *See Unocal*, 493 A.2d at 955 n.10. "It has been suggested that a board's response to a takeover threat should be a passive one. . . . However, that clearly is not the law in Delaware, and as the proponents of this rule of passivity readily concede, it has not been adopted either by courts or state legislatures." *Id.* (citations omitted).

[221] *See supra* Parts III.A, B.

shareholders the highest possible price for their assets.[222] Even assuming that the target's management will act in a self-interested way, some commentators have argued that some, but not all, target stock buybacks may increase shareholder wealth as a result of the instigated auction.[223] Statistical data have shown that the takeover premiums paid for U.S. companies are higher than those paid for European companies, which suggests that the widely used defenses in the U.S. could raise the premiums for the shareholders.[224] Still, there is leeway for the use of defensive tactics to benefit shareholders, leaving the indiscriminate prohibition of defensive measures as too simplistic a remedy.

As discussed earlier, the newly established takeover defense regime in China is riddled with problems.[225] Different jurisdictions have different models of takeovers: the U.S. model can be called the court-based model; the UK, the shareholder-based model; the Australian, the specialist-based model; while the Chinese model can be well described as the legislator-based model or "prohibitive model," which is characterized by paternalism and rigidity.[226] The six defenses listed in Article 33 have been sentenced to death by the draftsmen once and for all. There is no room for the regulated and regulators to assess whether defenses are appropriate in specific circumstances. This simplistic approach to takeover defenses needs to be reformed because it is unable to achieve the goals of contestability of takeovers and shareholder protection.

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[222]*See, e.g.*, Bebchuk, *supra* note 107, at 1034-38; Gilson, *supra* note 72, at 868-75; Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defenses*, 35 STAN. L. REV. 51 (1982).

[223]Michael Bradley & Michael Rosenzweig, *Defensive Stock Repurchases*, 99 HARV.L. REV. 1377 (1986); Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985). *But see* Jeffrey N. Gordon & Lewis A. Kornhauser, *Takeover Defense Tactics: A Comment on Two Models*, 96 YALE L.J. 295 (1986) (arguing that the target stock buybacks are unlikely to increase shareholder wealth as a general matter).

[224]Christian Kirchner & Richard W. Painter, *European Takeover Law—Toward a European Modified Business Judgment Rule for Takeover Law*, 2 EUR. BUS. ORG. L. REV. 353, 379-81 (2000). *But see* Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 8 (1982) (arguing that diversified shareholders who own both bidder and target company stock should be indifferent to bid price maximization).

[225]*See supra* Part V.A.

[226]Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1929-31 (1996) (describing "prohibitive model" as "a law that bars a wide variety of suspect corporate behavior in considerable detail").

1. The U.S. Model Cannot Take Root in China

The characteristic feature of the U.S. model is that management is granted wide discretion to implement defensive measures, subject to intense judicial supervision protecting the shareholder from the abuses of the defenses.[227] The courts, rather than the directors, are the arbiters of the proper use of specific defenses in particular situations and thus play a central role in the U.S. model. The work is difficult and requires judges that are experienced enough to fulfill this mission. In Delaware, where the majority of America's largest corporations are incorporated, corporate matters account for the bulk of the workload of Delaware's judges on the court of chancery.[228] To be able to handle disputes quickly and effectively, those judges have necessarily developed extensive and notable experience in corporate law issues.[229] All corporate matters are originally heard by the Delaware Court of Chancery and any appeals are taken to the Delaware Supreme Court.[230] The judges who sit on both courts are highly valued in Delaware and building a team of such highly qualified judges is extremely difficult.[231] Obviously, there is a long way for China to go to set up a comparable team of judges who are able to resolve complex takeover disputes effectively. Lack of qualified judges is a key factor in rejecting the idea to import the U.S. model into China.

Additionally, China's commercial environment is significantly different from that of the U.S., which provides strong disincentives to the misuse of defenses. There are, among other things, at least four important factors worth noting. First, in the U.S., management has long accepted the notion of shareholder primacy as a product of law and acculturation.[232] As a socialist state, however, China has to give more consideration to the benefits of the employees of companies in takeovers and the maintenance of social stability. This attenuates the board's sense of accountability to shareholders in China. The anti-takeover defenses could be justified for employee considerations, even if they are not in the best interests of shareholders. Worst of all, the concern of employee benefits could be

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[227] *See supra* Part V.B.1.

[228] Thompson, *supra* note 1, at 334.

[229] *Id.*

[230] *Id.*

[231] Delaware has a number of assets that are specific to its status as the foremost purveyor of state-of-the-art corporate law. As Professor Romano noted, these assets include the state's "comprehensive body of case law, judicial expertise in corporation law, and administrative expertise in the rapid processing of corporate fillings." ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 39 (1993).

[232] *See supra* Part III.B.

manipulated as a pretext for misusing defenses. Second, the heavy institutional investor ownership in large public firms in the U.S. makes management highly sensitive to public shareholder interests in considering a takeover bid, based on the fact that board members are elected by the shareholders on a yearly basis.[233] In contrast, the role played by institutional investors in corporate governance in China is rather weak.[234] In China, the term of directorship could be as long as three years, and the shareholders may not remove a director from office before the expiration of his term without reason.[235] This further reduces the shareholder influence in China. Third, independent directors in the U.S. place important checks and balances on the use of defenses.[236] This internal control within the board over the decision-making process is lacking in China.[237] Finally, executive compensation in the U.S. discourages management from using defenses for entrenchment purposes.[238] Stock options account for a large percentage of the compensation of U.S. managers.[239] Because a takeover always accelerates the vesting of options, managers are reasonably inclined to accept premium bids and could possibly make a large fortune overnight. Stock options, however, are not widely used in China as a form of compensation[240] and, thus, cannot provide incentives for the managers to accept a takeover bid that would increase the shareholders' value.

In fact, the U.S. model itself has received increasing criticism recently for weak shareholder protection and the unclear application of

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[233]JEFFERY N. GORDON, AN AMERICAN PERSPECTIVE ON THE NEW GERMAN ANTI-TAKEOVER LAW 6 (2002), *available at* http://papers.ssrn.com/abstract=336420.

[234]By the end of 2002, there were 126 securities houses, together with twenty-one fund management companies that managed seventy-one securities investment funds with assets of 131.9 billion yuan (roughly 15.9 billion U.S. dollars) in China. *See* Sun Min, *Clear-up Due for Securities Market*, ZHONGGUO RIBAO [CHINA DAILY] (Jan. 27, 2003).

[235]Company Law, *supra* note 50, art. 115.

[236]*See* Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 809 (2002); Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?* 55 STAN. L. REV. 819, 831 (2002); *but see* John C. Coates et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 898 (2002) (arguing that having a majority of independent directors does not address the concern that defensive tactics might be abused).

[237]Schipani & Liu, *supra* note 90, at 44.

[238]GORDON, *supra* note 233, at 7.

[239]David Yermack, *Do Corporations Award CEO Stock Options Effectively?* 39 J. FIN. ECON. 237, 238 (1995).

[240]Schipani & Liu, *supra* note 90, at 53.

fiduciary duty precedent in the context of takeovers.[241] As discussed earlier, the courts now apply a "modified business judgment rule" established in *Unocal* to limit managerial discretion and protect shareholders who complain that defenses are abused.[242] This rule, however, seems impotent. Robert B. Thompson and Gordon Smith have published the result of a survey in 2001 showing that of all Delaware cases applying the *Unocal* framework, few involved the invalidation of takeover defenses by the courts.[243] Because the courts often defer to the judgment of management when defenses are used, most case law under *Unocal* permits defensive measures to remain in place.[244]

Thompson and Smith also found that the number of *Unocal* claims decided by the Delaware courts has dramatically declined.[245] Thus, they concluded that "*Unocal*, as currently structured does not provoke judicial scrutiny of director defensive tactics that is at all 'enhanced,' as compared to the review provided under the traditional business judgment standard."[246]

The reasons for the deficiency of the checks put on the ability to use defenses by the target's management under *Unocal* largely lie in the "modified business judgment rule" itself.[247] As discussed earlier, this rule has introduced three significant components.[248] To begin, a procedural change shifts the burden of proof onto the defendant. This seemingly would have had a positive impact, but in fact has failed to have made any perceptible difference.[249] Second, defendants are required to prove that "they had reasonable grounds for believing that a danger to corporate policy

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[241]*See, e.g.*, Bebchuk & Ferrel, *supra* note 108; Thompson, *supra* note 1, at 335 (arguing that the anti-takeover regimes of "Australia, the United Kingdom, and other common law countries with developed securities markets do a better job of protecting shareholder space to make corporate decision in a takeovers context when the interests of directors may diverge from those of shareholders").

[242]*See supra* Part V.B.1.

[243]Thompson & Smith, *supra* note 180, at 284-86.

[244]In *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985), the Delaware Supreme Court upheld a "flip over" poison pill, which would allow remaining target shareholders to buy the acquirer's stock at half price if the acquirer merged the target corporation with the acquirer corporation after a hostile tender offer. The court pointed out that the pill was designed to protect the corporation's shareholders against a two-tier coercive offer by assuring that shareholders on the back end of a tender offer were adequately compensated. The Delaware Supreme Court rejected the claims that such a pill was not authorized by statute and that the pill violated the director's fiduciary duties.

[245]Thompson & Smith, *supra* note 180, at 284, 286.

[246]*Id.* at 283.

[247]Thompson, *supra* note 1, at 330-33 (arguing that the *Unocal* approach is impotent).

[248]*See supra* Part V.B.1.

[249]Gilson, *supra* note 72.

and effectiveness existed,"[250] and this evidentiary obligation could be discharged by "a showing of good faith and reasonable investigation."[251] This has turned out to be too easy a task because "anything seems to satisfy the showing of a threat, including an assertion that shareholders misperceive the value of the company."[252] Finally, the proportionality test seems to have suffered more serious problems. In 1995 when *Unitrin, Inc. v. American General Corp.* was decided,[253] this test was interpreted to be dependant on whether the defensive tactics were "coercive" or "preclusive."[254] The terms "coercive" and "preclusive" are so restrictively defined as to only include the most dramatic situations where the shareholders have no opportunity to exit.[255] If the directors could be removed by a proxy vote over a two year period, for example, the court would consider the test met, even though the defenses would have excluded shareholders from making a takeover decision.[256]

Thus, Delaware law appears to be far from ideal from the perspective of shareholder protection. Recent statistical evidence has shown a low probability of success for hostile takeovers in the U.S.[257]—obviously, this is not the outcome China would presently like to encourage. It is almost certain that the situation would be much worse if China were to import the U.S. system unchanged because Chinese judges are far less experienced than their American counterparts and would be far more hesitant to intervene in corporate matters, leaving management with greater discretion on the use of defenses.

2. The Australian Model is Worthy of Serious Consideration

It appears that the Australian specialist-model might address the above-mentioned concern about the experience of Chinese judges. The Takeovers Panel consists of specialists who have notable knowledge and experience in corporate matters, including academics and practitioners.[258]

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[250] *Unocal*, 493 A.2d at 955.

[251] *Id.*

[252] Thompson, *supra* note 1, at 331.

[253] 651 A.2d 1361 (Del. 1995).

[254] *Id.* at 1367 (citing Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 45-46 (Del. 1994)). The court held that "if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a 'range of reasonableness,' a court must not substitute its judgment for the board's." *Id.* at 1388.

[255] Thompson, *supra* note 1, at 331.

[256] *Id.*

[257] Kirchner & Painter, *supra* note 224, at 378-79.

[258] Walsh, *supra* note 198, at 438.

It has been recognized that "the very subject matter of the Panel's jurisdiction is a fast-moving, highly technical field with important financial and economic implications."[259] Thus, the merits of this system are that "'it provides greater certainty and a higher level of expertise than the previous court-based system which relied on Supreme Court judges around the country to review complex corporate matters and who generally did not have the day to day expertise of dealing with the issues.'"[260] Further, the Takeovers Panel is by nature quasi-private and procedurally more flexible than the judicial system.[261] This allows the Takeovers Panel to work more quickly and efficiently, which is very important for time-sensitive commercial arrangements such as takeover matters. In short, this system has received a warm welcome and has proven to be better than the previous court-based regime.[262]

After the 2000 reform, the Panel is independent of the Australian Securities and Investment Commission (ASIC).[263] It seems unrealistic that the central government in China will establish such an independent panel in addition to the CSRC, which has been officially empowered to regulate the securities market exclusively.[264] The possible solution in China is that the CSRC itself could establish such a special committee on the model of the Australian Takeovers Panel. This hypothetical committee would make its decision in the name of the CSRC, but it would function independently of the CSRC in its routine work and receive a specified amount of funding allocated by the CSRC. A detailed working procedure of this committee would be set out and its decisions made public. This committee would also provide reasons justifying its decision. Like the Australian Takeovers Panel, the members of this committee would be chosen from the experienced and knowledgeable practitioners and academics.

A committee of this kind is not foreign to the CSRC. There has been a special committee in charge of approving the issuing and listing of shares

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[259]G.F.K. Santow & George Williams, *Taking the Legalism out of Takeovers*, 71 AUSTRALIAN L.J. 749, 762 (1997).

[260]Clegg, *supra* note 214, at S-3 (quoting Chris Mackay, chief executive of UBS Warburg).

[261]Walsh, *supra* note 198, at 438.

[262]*See, e.g.*, Walsh, *supra* note 198, at 439 (contending that "the Takeovers Panel is preferable to the curial system for resolution of takeovers [sic] disputes").

[263]Prior to this, the Panel was dependant on the ASC (the predecessor to ASIC) for its funding, administration, and applications. *See* Barbara Mescher, *Regulation of Takeovers by the Corporations and Securities Panel: The Occurrence of Unacceptable Circumstances*, 4 AUSTL. J. CORP. L. 90, 94 (1994).

[264]Securities Law, *supra* note 51, art. 7. It reads that "[t]he securities regulatory authority under the State Council (the CSRC) shall, in accordance with law, implement centralized and unified regulation of the securities market nationwide."

(*Shangshi Faxing Weyuanhui*) within the CSRC.[265] This special committee also consists of learned experts in the relevant fields and functions relatively independently of the CSRC.[266] This seemingly remarkable system, however, suffers severe problems in practice. The biggest shortcoming of this committee is that all its members work part-time, and they often do not have enough time and energy to devote to in-depth deliberation and make appropriate decisions.[267] To prevent such problems from recurring, the hypothetical takeover committee should be comprised of a majority of full-time members who can devoted themselves to these important tasks.

Admittedly, however, the problems experienced by the *Shangshi Faxing Weiyuanhui* have clearly cast some doubt on the viability of the Australian model in China. Perhaps more importantly, the hypothetical takeover committee also needs to rely on the rules concerning directorial duties when making their decision, but Chinese law hardly provides such a basis, and Chinese experts are arguably much less experienced than their Australian counterparts.[268] Thus, it is debatable whether this proposed committee would function as expected in circumstances where directors' duties are not yet socially embedded.

3. The City Code, While Illuminating, Is Unsuitable for China

The main feature of the City Code is that it makes shareholders the final arbiters on the acceptability of takeover defenses.[269] Directors in this system play a largely passive role: the defense could be used only if the shareholders approve it in advance. Under this system, the target's shareholders will have an opportunity during the takeover bid to consider a tender offer on its merits and disapprove defensive tactics that would thwart an offer that might otherwise be beneficial to shareholders. Therefore, in theory, the City Code could yield the best protection for shareholders against management opportunism. Another benefit of this system is that against the complex and bewildering issues of directors' duties are not as pivotal as in the U.S. model because shareholders

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[265]See the CSRC's official website, *available at* http://www.csrc.gov.cn/cn/jsp/detail.jsp?infoid=1104476922100 (introduction of the special committee) (last visited Jan. 5, 2005). In addition, see Bao, *supra* note 41, at 68 for further discussion of these two points.

[266]*Id.*

[267]Interview with Zhuo Han, Department of Public Offering Supervision of the CSRC (Beijing, Sept. 4, 2003) (on file with author).

[268]*See supra* note 151 and accompanying text.

[269]*See supra* Part V.B.2.

themselves determine the use of defenses and, in fact, the ultimate destiny of the company.[270]

This, by its nature, reflects the different attitude towards the allocation of powers between directors and shareholders. Clearly, takeovers result in a change of control and thus have material effects on a company. In the face of such a critical event, it appears that a system like the City Code is preferable to the U.S. system because under the City Code, shareholders, as the ultimate owners of the company, have an opportunity to express their opinion in respect of their property rights, instead of managers making the decisions on their own in their capacity as agents.[271]

The City Code has received positive views from both academics and legislators.[272] Many commentators have advocated the City Code model and urged their own countries to move in that direction.[273] In Australia, it has been argued that the directors should desist from taking any action that may have the foreseeable effect of blocking the takeover without the prior consent of the shareholders.[274] American scholars also expressed their preference for the City Code, arguing that it "both addresses possible defects in the takeover process and ensures that shareholders, not management, have the ultimate say on whether a takeover proceeds."[275] Many countries, including Commonwealth countries such as New Zealand,[276] and European Union member states such as Ireland,[277] as well as many others,[278] have adopted a similar model to the City Code. The

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[270]For the discussion of directors' fiduciary duty in the context of takeovers in the U.S., see *supra* Part V.B.1.

[271]A counterargument is made that in a relatively efficient financial market, the shareholder choice standard like the City Code would encourage the "managers to adopt strategies that make hostile bids less likely to occur, even if those strategies reduce the ultimate value of the corporation to the shareholders." *See* Michael L. Wachter, *Takeover Defense when Financial Markets Are (Only) Relatively Efficient*, 151 U. PA. L. REV. 787, 794 (2003).

[272]*See* Farrer, *supra* note 178, at 40; Jensen, *supra* note 74, at 44.

[273]*Supra* note 272.

[274]Mayanja, *supra* note 164, at 191.

> To achieve effective shareholder protection in transactions involving the transfer of corporate control, it is advisable that Australia adopts a rule that allows target directors no discretion whatsoever to frustrate unsolicited takeover attempts. This, in turn, can be achieved by requiring prior shareholder approval of any action proposed to be taken by directors which may have the foreseeable effect of blocking an offer.

[275]Bebchuk & Ferrel, *supra* note 108, at 1193.

[276]*See* Mayanja, *supra* note 164, at 177-80 (discussing the takeover regime in New Zealand).

[277]Takeover Rules, art. 21 (1997) (Ir.).

[278]*See* Ferrarini, *supra* note 122, at 15-16, specifically nn.64-76 (providing a detailed list of twenty other countries following the model of the City Code).

proposed 13th Directive on Takeover Bids of European Union in 1999 also follows this model,[279] and some Chinese commentators have also expressed support for this model.[280]

The City Code, however, is also beset by a number of serious problems in practice. Notably, the so-called collective action problems, including widespread rational apathy among shareholders and free riding, have discounted the function of shareholders' meeting as an effective mechanism.[281] It has been argued that the approval process of the City Code is "in most cases impossible to use because the notice and preparation period for a general shareholders' meeting is too long."[282] Especially in the context of takeovers, which are by nature time-sensitive commercial arrangements, the time the shareholders have before reaching a decision is critical and always very limited.[283] The shareholders' meeting would take considerable time even if the shareholders are willing to take part in the meeting, and the delay would prevent the directors from making proper use of defenses to ward off bids offering an inadequate price or posing threats to the company. Largely for this reason, the proposed 13th Directives on Takeover Bids of the EU was rejected on July 4, 2001.[284]

This problem is particularly severe and disconcerting in China, where shareholders consist mostly of retail investors[285] who are more inclined to exhibit rational apathy and free riding. Further, due to monetary constraints and the problems imposed by communication and transportation systems in need of modernization, it is not surprising that the time taken to hold a shareholders' meeting in China would be much longer than other countries that adhere to the City Code model. Furthermore, the frequent

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[279]*See* Kirchner & Painter, *supra* note 1, at 455-58 (providing a detailed account of the proposed Thirteenth EU Directive on Takeover Bids).

[280]FANG ZHANG, GONGSI SHOUGOU FALU ZHIDU YANJIU [RESEARCH ON CORPORATE TAKEOVERS LEGAL FRAMEWORK] 238 (1998).

[281]*See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 82-89 (1991) (discussing this problem in detail). *See also* Paul Redmond, *The Reform of Directors' Duties*, 15 U. NEW SOUTH WALES L.J. 86, 92 (1992) (discussing the same issue in depth).

[282]Kirchner & Painter, *supra* note 1, at 457.

[283]Walsh, *supra* note 198, at 436.

[284]Kirchner & Painter, *supra* note 1, at 460-61 (stating that several member states were afraid that the rule would make European corporations too vulnerable to hostile takeovers from the U.S.).

[285]The role played by the institutional investors in China is very limited. As of the end of 2003, there have been only seventy-one investment funds in China at present, including fifty-four closed-ended funds and seventeen open-ended funds. The funds account for only 10.03% of the total trading volume in the A share market in the first half of 2003. *See* Lifeng Hu, *No Longer Loss-Making: The Achievement of Funds in the First Half of 2003*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES NEWS] (Sept. 1, 2003).

shareholders' meeting would result in considerable costs to Chinese corporations.[286] Thus, the City Code model cannot be imported to China wholesale. The City Code, however, illuminates a step in the right direction in that it provides shareholders with an opportunity to decide the use of defenses.

4. A New Scheme: Shareholders *ex Post* Veto the Use of Defenses

A system where shareholders could *ex post* veto the use of defenses by management could overcome the problems of time and costs associated with *ex ante* shareholder approval.[287] This approach enjoys two significant advantages. On the one hand, it shares a key feature of the City Code because shareholders are granted an opportunity to approve or disapprove of defensive measures from their own perspective and, thus, could be best protected in the takeover context. On the other hand, management could respond quickly to takeovers and avoid any disastrous delay. This flexibility is necessary in a rapidly changing and complex commercial environment. Some commentators believe that a target's board is in a better position to make the initial decision on the use of takeover defenses because "a firm's true economic value is visible to well-informed corporate directors but not to company's shareholders or to potential acquirers."[288] Further, compared to the City Code where every defense needs to be approved by the shareholder meeting, this system would result in a reduction of shareholder meetings because shareholders would not meet to veto a defense that they think is in their best interests. Thus, the costs incurred by the company would be diminished.

At the heart of this system, shareholders would have the opportunity to veto defensive measures immediately after they are implemented. The willingness of shareholders, especially institutional investors, is reinforced by the fact that in the context of takeovers, the possibility of gain or loss due to the notable change in the share price is large.[289] This creates an opportunity to reap handsome short-term profits based on the premium

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[286]In practice, holding a shareholders' general meeting is costly, specifically in costs associated with: notification, registration, venue rent, meeting materials, manpower, etc. Thus, the CSRC has specified in detail the procedures and requirements for holding shareholders' general meetings. *See* Shangshi Gongsi Gudong Dahui Guifan Yijian [Rules for Standardizing Shareholder's General Meetings of Listed Companies] (promulgated 1998 and revised 2000 by the CSRC).

[287]Kirchner & Painter, *supra* note 1, at 472-74.

[288]Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 521-22 (2002).

[289]EASTERBROOK & FISCHEL, *supra* note 281, at 79.

offered by the bids.[290] So, even assuming a skeptical attitude towards institutional shareholders' activism,[291] it is reasonable to make an exception and argue that they will take an active role in response to takeovers, in light of the short-term profits that such conduct might generate. Because the shareholders would only veto undesirable defenses (i.e., those that materially harm them), the shareholder meeting would not be held with excessive frequency, leaving shareholders to concentrate their limited time, money, energy and interests to attend those truly important meetings. With the help of modern technology such as the Internet, the veto system could be more feasible and function more efficiently.[292]

It is important, however, to note that the collective action problem connected with the shareholders' meeting would still exist in this system. To alleviate the concern that the directors would enjoy virtually full discretion if the shareholders seldom hold the meetings, the shareholders could *ex ante* set out the types of defensive measures available to the directors in the annual meeting. Since the defenses would materially impact the company, they must be approved by a special majority according to the Company Law.[293] The directors could only use those approved defenses in appropriate circumstances, for example, to repel a bid at an insufficient price. This approval would have to be renewed over a specified period of time, such as one year, yet if it is found that the directors have misused certain defenses, the shareholders would be able to remove those defenses from the approval list at the next annual meeting.[294] In other words, the list is decided by shareholders, not directors or, specifically, by legislators as shown in China's model.[295] This model would provide the shareholders with enough flexibility to adjust the list according to changing situations and create a further check on the discretionary power of the directors. The July 2001 version of the German Takeover Code adopted

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[290]Takeovers are value creating transactions. *See supra* note 50 and accompanying text.

[291]EASTERBROOK & FISCHEL, *supra* note 281, at 80; Redmond, *supra* note 281, at 92.

[292]Some commentators have recommended Internet-vetoing system. *See* Kirchner & Painter, *supra* note 1, at 472. Qiang Hua, *The Test of the Internet Voting System for Shareholder's General Meetings has been Successful in the Shanghai Stock Exchange*, ZHENGQUAN SHIBAO [SECURITIES TIME NEWS], June 30, 2004, at 1 (reporting that the Shanghai Stock Exchange has successfully tested its high-tech on-line voting system to facilitate shareholder's general meetings).

[293]Company Law, *supra* note 50, art. 106 ("Resolutions on the merger, division or dissolution of the company adopted by the shareholders' general meeting, must require more than two-third of the voting rights held by the shareholders present at the meeting.").

[294]Shareholders would be able to retain those removed defenses if they are deemed necessary thereafter.

[295]*See supra* Part V.A.

this strategy.[296] This added measure would impose fewer costs on the company and the shareholders because annual meetings would continue to be held.

The appropriateness of this new anti-takeover scheme in China is further bolstered by the fact that the Company Law has already put many limits on the use of defenses. Some widely used defensive measures in the U.S. cannot be used in China. Poison pills, for example, would probably violate the Company Law in that companies are prohibited from issuing shares at a discount in order to dilute the capital of the bidder.[297] Further, the rules on equal treatment of shareholders would forbid the bidder's discrimination with regard to the issuance of shares that are determined by the poison pill.[298] In addition, Company Law expressly prohibits the practice of repurchasing, which is a common defense in the U.S.[299] In China, all major measures, including issuing new shares, amending the articles of association, and increasing or reducing the company's capital need shareholders' approval.[300] In short, China's commercial law framework has, in fact, ruled out many U.S. defenses and, therefore, decreased the possibility of the misuse of defenses by directors.

Article 33 of the Measures for Regulating Takeovers has, in fact, prohibited those types of defenses that would require the approval of the shareholders in any event according to the Company Law.[301] This fact clearly signals that the drafters are deeply skeptical of the role shareholders play and reflects a paternalistic approach toward the use of defenses. In other words, the governmental drafters trust neither the directors, the shareholders, nor the courts, but only themselves. As argued above, the shareholders, especially institutional investors, would have the incentives and capabilities to use their rights.[302] Even if it is conceded that

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[296]Bundesrat-Drucksache, 14/7477. In pertinent part, it reads: "Authorization from a shareholders' meeting, that before the time period of the offer authorizes a management board to undertake measures that will hinder the success of the offer, shall specify these measures in the authorization in detail." German Government Draft Takeover Law, July 11, 2001, Sec. 33(2).

[297]Company Law, *supra* note 50, art. 131 (providing "shares may be issued at or above par but not below par").

[298]The discrimination amongst shareholders of the same class is prohibited by the principle "Tonggu Tongquan, Tonggu Tongli" of the Company Law, which means "equal share equal rights, equal share equal benefits." *See also* Securities Law, *supra* note 51, art. 4 ("The parties involved in the issuing and trading of securities shall have equal legal status.").

[299]Company Law, *supra* note 50, art. 149 ("[A] company may not purchase its own shares except where, for the purpose of reducing its capital, shares needs to be cancelled, or where the company merges with another company that holds its shares.").

[300]*Id.* art. 103.

[301]Measures for Regulating Takeovers, *supra* note 2, art. 33.

[302]*See supra* notes 289-91 and accompanying text.

shareholders, in general, are currently unsophisticated, the sensible legislative attitude is to gradually cultivate them in practice rather than passively ignore them. Under this paternalistic attitude, the shareholders will never learn to make independent decisions regarding company affairs. Professors Bernard Black and Reinier Kraakman have argued that the emerging economies should adopt a self-enforcing model, rather than a prohibitive model, on the basis of the prevalence of insider-controlled companies and the weakness of other institutional, market, cultural, and legal constraints.[303] In this self-enforcing model, the shareholders could better protect themselves from management opportunism by shareholder meetings, with minimal resort to legal authority, including regulators and courts. In contrast, the prohibitive model, as exemplified by Article 33 of the Measures for Regulating Takeovers, imposes major costs on companies by "mechanically limiting the discretion of corporate managers to take legitimate business actions."[304] As an emerging economy, China should model its takeover law on this self-enforcing model for the purpose of shareholder protection while simultaneously preserving managerial discretion.

VI. CONCLUSION

Along with other legislation, the two recently promulgated rules relating to takeovers by the CSRC have greatly completed China's takeover legal framework and are now forming a sound basis for takeover activities. The Chinese takeover law, however, is not immune to criticism, even though the law has been seen as a laudable achievement.

In principle, China's takeover law should be carefully designed to achieve two goals: contestability of takeovers and investor protection. Two closely connected parts of takeover law are examined on a comparative basis: takeover and takeover defenses. Those rules regarding information disclosure and tender offer are suitable for China, and there is no compelling reason to vary them.

There is, however, a notable divergence in the rules concerning takeover defenses on an international level. China's relevant rules unfortunately suffer serious problems. For example, Chinese rules limit the ability of directors to thwart unsolicited takeovers by arbitrarily choosing certain types of defensive measures and prohibiting their use in any

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[303]Black & Kraakman, *supra* note 226, at 1932; Thompson, *supra* note 1, at 324 (stating that "[m]y preference is for a greater reliance on shareholder self-help in resolving disputes about the extent of takeover regulation").

[304]Black & Kraakman, *supra* note 226, at 1931.

circumstance, irrespective of whether those defenses are improperly used. In addition, other unlisted defenses remain unaddressed; in short, the rules are both over-inclusive and under-inclusive. China cannot adopt the U.S. court-based model or UK City Code model. The Australian experience, establishing a specialist body to deal with takeover disputes, has some appeal in the context of China. There is, however, some doubt on the importability of this model, even though scholars contend that China should seriously consider it.

To create a better balance between the contestability of takeovers and investor protection, shareholders should have the final say on the use of defenses. In China, the best method for realizing this goal is implementation of a system whereby shareholders could *ex post* veto the use of defenses, and enumerate *ex ante* the general availability of certain defensive measures at the annual shareholders' meeting. Under this *ex post* veto system, reinforced by the *ex ante* approval strategy, it seems that shareholders could get sufficient protection while, at the same time, preserve necessary flexibility for management to efficiently respond to takeovers. Thus, this system is the best possible model that China should incorporate into its takeover law regime.