Active or Passive?---Rethinking Directors’ Roles in an Anti-takeover Process

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Introduction

In this article, “takeovers” refer to activities of acquiring shares to obtain the actual control of a listed corporation (the target corporation) by the bidder. And “anti-takeovers” refer to activities of employing defensive tactics to prevent the controlling power of the target corporation being taken away from the original controller.

In many jurisdictions, scholars generally regard the existence of the takeover markets to be good because it could, at least, assist maintaining good corporate governance and generating economic welfare. So it is important, in this article, to ask why the target corporation should sometimes fight against takeovers, and who should decide whether to resist it or not. In other words, during the takeover process, should the directors be in an active position to make the defensive decision and to defend the takeover or should they be in a passive position and let the shareholders decide the merit of the bid on their own?

Instead of adopting the traditional comparative law method and examining the practice of the major countries carefully, I will present the worldwide debate on
whether the directors should play an active role or a passive role in the anti-takeover process by briefly introducing several countries’ practices. Then I will explore the best practice from a purposive perspective, which is to consider the directors’ roles in light of the purpose of the defensive tactics. And also I will try to defend my conclusion against the potential counter-arguments. Finally, I will look at China’s practice and examine whether the best practice is suitable for China at present.

The Debate
i) Practice in the United States

In the U.S., the “courts typically have held that the target corporation’s management has the right, and even the duty, to oppose a tender offer it determines to be contrary to the firm’s best interests.”¹ Therefore, making defensive decision and defending a harmful takeover are the business of the directors in the target corporation. In other words, directors should play an active role in the anti-takeover process if the takeover offer is identified “to be contrary to the firm’s best interests”.

In Cheff v. Mathes,² the Business Judgment Rule was introduced to protect the directors who were acting in good faith and pursuing “a ‘business purpose’ that would benefit the corporation;” that is, if the directors made the defensive decision in good faith and in the interests of the corporation, they would not be blamed for it. Later this

² 199 A.2d 548 (Del. 1964)
Rule was furtherly developed in *Unocal v. Mesa Petroleum*\(^3\) and it was held that “a board of directors may only try to prevent a take-over where it can be shown that there was a threat to corporation policy and the tactic used was proportional and reasonable given the nature of the threat.” This was the Unocal test and it was then supplemented to in *Unitrin, Inc. v. American General Corp.*\(^4\) In this leading case on the directors’ power to take defensive measures, the Supreme Court stated that before the courts step in the corporate governance which is regarded as the business of the directors, the courts must believe that “the defensive measure is draconian in that it has the effect of precluding or coercing shareholders choice.”

In conclusion, it is the directors that could and should decide the defensive measures against a hostile takeover in the U.S. And as long as the courts are satisfied that i) the defensive measures are coercive or preclusive to shareholders choice; and ii) there isn’t any threat to corporation policy; or iii) even if there is threat, the defensive measures are not proportional and reasonable in response to the threat, the directors will not be protected by Business Judgment Rule and should be liable to shareholders for making the defensive decision.

ii) **Practice in the United Kingdom**

In the U.K., the main rules regarding takeovers is the “City Code on Takeovers and Mergers” (“the Code”) which was issued by the Panel on Takeovers and Mergers.

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\(^3\) 493 A.2d 946 (Del. 1985)
When talking about the defensive power, the general principles state that,

“The holders of the securities of an offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid; where it advises the holders of securities, the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company’s places of business.”

The board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid.”

It is likely, therefore, that in the U.K., the shareholders are granted with the decision power to “decide on the merits of the bid” and the directors should play a passive role in the anti-takeover process. The only obligation of them is to “give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company’s places of business” and “act in the interests of the company as a whole.”

iii) Practice in Germany

In Germany, the activities of anti-takeovers do not occur frequently because the
company law or other relevant laws within the jurisdiction have already provided sufficient barriers to deal with hostile takeovers. For example, in a German joint-stock company, the directors’ term of office is normally five years and they cannot be replaced unless very rare situations happened and also in that case, the resolution to replace the directors has to be adopted by shareholders representing 3/4 or more of the voting rights.

As a result, in countries like Germany the discretionary power of the target corporation is limited when facing with takeovers. So there is no sufficient space to talk about whether the directors play an active role or not.

Should the Directors Be Active or Passive?

i) A Purposive Perspective

Before answering the question, should the directors be active or passive during the hostile takeover process, we must firstly identify and explore some other questions: is the takeover always beneficial? Who will benefit from it and who will be harmed by it? Why does the target corporation want to resist the takeover in some circumstances?

Who should be protected?

Firstly, it is arguably believed that takeovers could help to restructure the whole industry and enable a more efficient production. However since it also provides an opportunity to create monopolies, things may go to the contrary and production
becomes less efficient.

Secondly, someone argues that “a cash tender offer at a premium over the market price gives each shareholder the opportunity to obtain, with certainty, a return exceeding the current market value of the target corporation's stock.” Consequently, “allowing the target corporation's management to engage in defensive tactics in response to a tender offer decrease shareholders’ welfare... [Because the] defensive tactics result in a defeat of a takeover, causing shareholders to lose the tender premium.”

However, even in a mature market where the share price is positively associated with the value of the corporation, the shareholders of the target corporation are not necessarily able to evaluate the real value of their corporation in light of its share price. For example, a great development plan of the target corporation is in embryo and the bidder knows it through a certain channel. However this information has not been disclosed to the public or to shareholders because this is not the proper time. As a result, the shareholders may be willing to sell all or part of their shares to the bidder simply because the bidder offers a premium over the market price. Apparently in cases like this which frequently happened everywhere over the world, shareholders can only make decisions, to sell their shares or not, based on partial information. And they barely have chance to obtain a comprehensive knowledge about the corporation’s

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7 Ibid, FN.1
8 Ibid, FN.1
development plan and its real value. And worse still, their lack of information could make them suffer from selling the shares to the bidder.

Not to mention that in practice, most of the investors are lack of professional skills and they could hardly evaluate the true value of a corporation; or even they could, it will cost them a lot. And it is likely that most individual shareholders won’t bother to do this burdensome valuation before selling their shares especially when they hold shares in many different corporations.

Things are worse in some jurisdictions where the markets are immature and the share price of a corporation is usually not connected with the real value of the corporation at all. Shareholders in these jurisdictions could potentially suffer more in accepting the tender offer because even the share price cannot be referred to.

Thirdly, it was said that the potential takeovers could encourage directors to work harder so that they could avoid being replaced by others. This is what I mentioned at the beginning of this article: takeover markets assist in improving corporate governance and generating economic welfare. Meanwhile, if the target corporation is purchased by a bidder successfully, a new management will probably be elected and the target corporation is supposed to perform better under the new control or the bidder won’t purchase this corporation in the first instance: this also assists to improve the corporate governance of the target corporation.
However, takeovers do not necessarily result from poor corporate governance and sometimes bidders decide to purchase this target corporation simply because it is attractive. Moreover, no one can be sure that the new board of directors would conduct better governance as the bidder previously thought. In addition, if the original directors performed badly, the shareholders could replace them by reelecting through the shareholders meeting. And compared with, the way of takeover is too radical and costly.

Furthermore, the new controller, after the takeover, may take measures to restructure the corporation and this may frustrate the long-term development plan previously designed for and implemented within the corporation, which will probably threaten the target corporation’s prosperity. For example, in *Cheff v. Mathes*, Cheff believed that the bidder posed a threat to the target corporation’s continued existence because the bidder considered that the target corporation’s door-to-door sales tactic, which employed a large workforce, was obsolete and should be abandoned in favor of a wholesaler marketing strategy. And this idea has caused the target corporation “to begin losing many of its employees, who were quitting in anticipation of the threatened takeover”. Therefore to resist the takeover, the directors of the target corporation authorized the payment of greenmail to the bidder.⁹

⁹ See also, http://en.wikipedia.org/wiki/Cheff_v._Mathes
Or when the new controller wants to restructure the corporation, the benefits of the non-investor groups will be touched, like the employees of the corporation, the creditors, and customers and so on. Should their benefits be protected? It relates to the theory of corporate responsibilities.

This theory requires the corporation being liable not only to its shareholders but also to the whole society, including the employees of the corporation, the creditors, the customers, the community and even the state. Specifically, it is the directors that perform such duties on behalf of the corporation.

As this theory becomes more and more popular in commercial societies all over the world, the non-investor groups’ benefits should be considered when making business decisions including deciding whether to resist the takeover or not. For example, the work opportunity for the employees should be considered when reducing the staff; the environmental liability owed to the community should be taken into account when deciding to expand the size of the corporation; and questions like, after the restructurinig, how the corporation would deal with the existing customers who have been protected by the old after-sale services should also be thought about carefully, etc.

In conclusion, because the defensive tactics are employed to avoid the “ignorant” shareholders being harmed, or to protect the target corporation’s long-term
development, or to defend the non-investor groups’ interest, it is likely that the directors should undertake the power, or even the duty, to decide whether to take defensive measures and resist the hostile takeovers, based on their professional skills, their comprehensive understanding about the target corporation, and duties owed to non-investor groups under the modern theory of corporate responsibilities. In other words, from the purposive perspective, the directors should play an active role in defending the hostile takeover as the U.S. practice.

Notably, Germany’s practice should not be preferred since takeovers do have their own advantages as stated earlier.

ii) Other Justifications of Directors’ Active Role in Anti-takeovers

It is argued that the directors do not have right to choose the shareholders of the corporation so that they could not decide whether to resist the takeover or not. And secondly, there is a conflict of interest for the directors during the deciding process. I will explain the issues, respectively, to justify the directors’ role in the anti-takeover process.

Regarding the first issue, when resisting the takeover, the directors are not preventing the bidder from becoming a shareholder of the corporation. And the impact of the defensive tactics is to prevent the bidder from obtaining the controlling power of the corporation. For example, to defeat the tender offer, the target corporation may
employ defensive tactics like “sell new shares to dilute the offeror's holdings” which, apparently, will not restrain the shareholders from surrendering their shares freely in compliance with the private law principles.

Or in some other circumstances, the defensive tactics may at most indirectly influence the transaction between the shareholders and the bidder when the target corporation try to persuade the shareholders not to sell their shares to the bidder or to bribe the bidder and ask him not to keep chasing the target corporation, etc. But none of the tactics will grant power to the directors of choosing shareholders they favored.

Regarding the second issue of the conflict of interest, it is argued that the directors of the target corporation “have a substantial interest in preserving their company's independence and thus preserving their salaries and status… They may disguise a policy of resistance to all offers as a policy of searching for a better offer than any made so far.”

Though the conflict of interest potentially exists, the pattern that directors should play an active role cannot be abandoned easily; that is, if this potential risk could be minimized by some necessary modifications, we should stick with this pattern.

In the U.S., in order to guarantee the directors to make decisions carefully and

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10 Ibid FN.1
honestly and not simply in their own interests, the Business Judgment Rule was introduced in the first instance to impose duties on the directors. Apart from this, the directors are also imposed by duties like duty of care, duty of loyalty, duty of being entirely fair to the shareholders and the like. And in some transactions, expert advice is required for the directors to make the defensive decisions.

Furthermore, in the U.S., the independent directors are prestigious and could oversee the action and decisions of the board of directors relatively well. And the advanced public media and the protection of press freedom could also contribute largely to the supervision of the board of directors during their decision-making process.

In addition, in the U.S., the litigation remedy for the shareholders is liberal so that the directors’ action could be well supervised by shareholders. Not to mention that the judges in the U.S. are experienced and capable of protecting the relevant parties’ interest when they are harmed by the directors’ improper or unlawful action. And it is likely that a clearer standard has been established by cases.

Finally, suppose the directors are acting passively and the shareholders were granted the power to decide the defensive tactics, the shareholders will also be put in a conflict of interests because they are required to take into account, when making the defensive decisions, their own interest, the corporation’s interest and the non-investor groups’ interest. And apart from that, they have to strike a balance among all of them,
because after all, the old period when the shareholders’ interests always prevail is gone.

**The Practice in China**

The main resource of rules about anti-takeover in China is the “Measures for the Administration of the Takeover of Listed Companies” adopted by the Chinese Securities Regulatory Committee.

Art.7 regulated duties of the controlling shareholder or the actual controller of the target corporation and stated that “no controlling shareholder or actual controller of a target corporation can misuse the stockholder’s rights thereof to damage the lawful rights and interest of the target corporation or any other shareholder.”

Art.8 presented the directors and other management’s duties that “the directors, supervisors and senior managers of a target corporation shall assume the obligation of fidelity and diligence, and shall equally treat all the purchasers that intend to take over the said corporation.

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

And Art.32, when dealing with the role of directors in the takeover process, stated that “the board of directors of the target corporation shall investigate the capacity, credit status and purpose of takeover of the purchaser, analyze the conditions for tender offer, put forward suggestions on whether the shareholders should accept the tender offer, and hire an independent financial consultant to issue professional opinions.”

As a result, Chinese law is vague as to who has the power to resist hostile takeovers. Art.32 seems to authorize the power to the shareholders and meanwhile the directors could only give opinions, but it is also likely that Art.8 contrarily grants this power to the directors.

According to stated above, the best practice is that the directors should play an active role in defending the hostile takeovers based on a purposive perspective and the self-contained remedy systems as that in the U.S. And because the purpose of the defensive tactics is to avoid the “ignorant” shareholders being harmed, or to protect the target corporation’s long-term development, or to defend the non-investor groups’ interest, which could apply in almost all of the commercial societies. Then the only issue, in deciding whether it is suitable for current China to enable directors playing an active role in the anti-takeover process, is whether China has sufficient
self-contained remedy systems like those in the U.S., including the director-responsibility system, the supervision system and shareholder-protection system. But after careful investigation and observation, I found that China’s existing remedy systems are not satisfactory.

Firstly, regarding the statutory duties of directors, only the obligations of fidelity and diligence are imposed by law and the wording is too abstract. In some circumstances, the judges may be reluctant to interpret the obligation liberally because they are cautious of intervening the directors’ discretionary power and afraid of disturbing the corporation’s ordinary business decision making.

This also relates to the judges’ lack of experiences in this area. Takeovers and anti-takeovers are still fresh in China and there are no sufficient test cases. Not to mention that the litigation remedy in China is not liberal as in the common law jurisdictions and shareholders may need strict standing to sue in the courts. For example, the threshold of the shareholders derivative action is quite high and the strict cause of action is impliedly required so that lots of actions would be ruled out of the courts.

In addition, the independent directors have been introduced by Chinese Company Law to, along with the board of supervisors, oversee the action and decisions of the board of directors. But whether they are functioning efficiently within the corporation
is questionable because of their close relationship with the board of directors.

And though the public media starts to play a bigger role in supervising the corporations, their historical insufficient independence and lack of professional ethics make them less reliable.

Therefore the U.S. practice is rational in my view, but China needs more improvement upon the matching systems before enabling the directors to solely decide the defensive tactics during the anti-takeover process. And meanwhile, before the adoption, China could gradually adopt the U.S. practice by granting part of the defensive power to directors while employing certain defensive tactics which are better to be initiated by the directors. In this way, the independent directors, the board of supervisors, the public media and the courts could all get more opportunities to enrich their experiences and sharpen their functions.

Conclusions
In conclusion, Germany’s practice should not be favored since takeovers do have its own advantages. As to whether the directors should play an active or a passive role, since the purpose of defending the hostile takeovers is: to avoid the shareholders surrendering their shares at a low price, to prevent the target corporation’s long-term development from being damaged by restructuring, to protect the non-investor groups based on the theory of corporate responsibilities, it is likely that the directors of the
target corporation are more appropriate to play an active role in taking defensive
tactics rather than let the shareholders decide on their own due to the directors’
comprehensive understanding about the target corporation, their professional skills
and their natural duties to the non-investor groups on behalf of the target corporation.

Moreover, by defending the hostile takeovers, the directors are not preventing the
bidder from being the shareholder of the target corporation or preventing the
shareholders from exercising their transfer rights freely because the defensive tactics
are simply stopping the bidder from being controlling the target corporation.

Regarding the conflict of interest, the directors could be regulated by self-contained
remedy systems including the director-responsibility system, the supervision system
and shareholder-protection system like those in the U.S. Not to mention that the
conflict of interest also exists when the shareholders are granted the power to decide
the defensive tactics on their own because they are required not only to consider their
own interest but also to consider the corporation’s interest and the non-investor
groups’ interest.

The conclusion that “directors should play an active role in the anti-takeover process”
is justified by the above factors but it is not suggested to uphold this best practice in
China at present, when most matching systems are not functioning efficiently.
Therefore, China could gradually grant part of the defending power to directors and
enable the independent directors, the board of supervisors, the public media and the courts to get more opportunities to enrich their experiences and sharpen their functions.

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