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Chinese Takeover Law: Revisiting the Director's Duty of Care Under Takeover Defence and the Business Judgment Rule

Dr Lu Lerong

Ci Ren*

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Abstract

This article discusses and analyses the Chinese takeover law with a focus on the director's duty of care under takeover defence. Directors of the target company are asked to act prudently and carefully in securing the best deal for the target company and its shareholders. However, due to the intrinsic conflicts of interest between directors and other stakeholders during the course of takeover, it remains difficult to effectively judge whether directors fulfil such duty or not, in particular when Chinese law in this area lacks clarity and comprehensiveness. The article evaluates certain drawbacks of the Chinese takeover law and then refers to the US judicial experience in this area, such as the well-known business judgement rule. It explores the feasibility of introducing the US-style business judgement rule into China based on the country's market reality and unique legal environments.

Introduction

Since the 1980s, an increasing number of corporate takeovers and relevant defensive tactics have been widely observed across the world, in particular, in some developed countries like the United States (US). For example, nearly $1.3 trillion worth corporate assets had changed hands from 1980 to 1990, which dramatically altered the US economy by moving large enterprises towards specialisation and made US corporations more competitive than their peers in the rest of the world.[1] Corporate raiders like Carl Icahn[2] and Thomas Boone Pickens[3] have become household names

* [XXX]

[1] Andrei Shleifer and Robert W. Vishny, "The Takeover Wave of the 1980s" (1990) 249 *Science* 745.

[2] Carl Icahn (born 16 February1936) is an American businessman and philanthropist who founded the Icahn enterprises, a holding company based in New York City with a diverse portfolio. In the 1980s, Icahn earned a reputation as corporate raider after making significant profits from the hostile takeover and asset stripping of the American airline TWA. See Barbara Kiviat, "10 Questions for Carl Icahn" *Time* (15 February 2007), available at: *http://content.time.com/time/subscriber/article/0,33009,1590446,00.html* [Accessed 9 September 2021].

[3] Thomas Boone Pickens Jr. (22 May 1928 to 11 September 2019) was an American oil and gas entrepreneur and a defender of shareholder rights who was based in Texas and chaired the hedge fund BP Capital Management. He was a well-known takeover operator during the 1980s when he threatened to take big oil companies over until they bought back his shares at lifted prices. See Jonathan Kandell, "T. Boone Pickens Is Dead; Oil Magnate and Corporate

in the US. Approximately half of major US corporations had received takeover offers in the 1980s,[4] with at least 143 (or 28%) of the 500 largest industrial corporations (which are commonly known as the *Fortune* 500 companies) being acquired over the time period.[5] According to the Institute for Mergers, Acquisitions and Alliances, the total value of global mergers and acquisitions (M&A) in 2019 amounted to $3.7 trillion across 49,849 deals.[6] Therefore, over the past few decades, a series of laws and regulations targeting corporate takeover and takeover defences have been promulgated to cope with the rapid expansion of corporate acquisition practices in the US and other developed countries.[7]

In contrast, the corporate world and capital markets in China are still at a nascent stage, as China launched the market-oriented economic reform at the end of 1970s and re-established its stock exchanges in Shenzhen and Shanghai in the early 1990s.[8] In 1993, China witnessed its first case of corporate acquisition through equity purchase on the secondary market. At that time, China Bao'an Group purchased the majority of Yanzhong Industrial (now Founder Technology)'s circulating shares on the stock market and then became the latter's majority shareholder.[9] This episode is widely known as the "Baoyan Incident" in China, after which the first round of takeover and anti-takeover activities flourished in China's capital market.[10] In 2001, China was granted the membership to the World Trade Organization (WTO), when it saw an explosive growth of listed companies conquering public shares of each other and competing for the corporate control of other businesses.[11] In 2005, inbound and domestic deals worth $46 billion were completed in China, an increase of 34% from the figure in 2004, whilst the outbound deals accounted for another $7-billion transactions.[12] More recently, China's capital markets have undergone further reforms in two areas which has strengthened the market discipline and creates better legal and economic environments for corporate M&A. First of all, in July 2019, China launched the Science Technology Innovation Board (or STAR market) at Shanghai Stock Exchange, which is a new trading platform exclusively for high-tech and innovative

Raider Was 91", *The New York Times* (11 September 2019), available at: *http://www.nytimes.com/2019/09/11/business/boone-pickens-dead.html* [Accessed 9 September 2021].

[4] Mark L. Mitchell and J. Harold Mulherin, "The Impact of Industry Shocks on Takeover and Restructuring Activity" (1996) 41 *Journal of Financial Economics* 193.

[5] Gerald F. Davis, Kristina A. Diekmann and Catherine H. Tinsley, "The Decline and Fall of the Conglomerate Firm in the 1980s: The Deinstitutionalization of An Organizational Form" (1994) 59 *American Sociological Review* 547.

[6] Statista, "Global mergers and acquisitions 2019—Statistics & Facts", available at: *http://www.statista.com/topics/6022/global-manda-2019/* [Accessed 9 September 2021].

[7] The US framework for regulating takeovers is based on a variety of sources of laws, including federal statues, state statues and judicial decisions interpretating common law duties. For instance, the State Corporate Laws, the Federal Securities Laws, the US Hart-Scott-Rodino Antitrust Improvements Act, among others.

[8] See Shanghai Stock Exchange Official Website, "About SSE", available at: *http://www.sse.com.cn/aboutus/overview/*, and Shenzhen Stock Exchange Official Website, "About SZSE", available at: *http://www.szse.cn/aboutus/index.html* [Accessed 9 September 2021].

[9] Jane Fu, *Corporate Disclosure and Corporate Governance in China* (Alphen aan den Rijn: Kluwer Law International, 2010), p.202.

[10] "Bao" refers to Baoan Group, "Yan" refers to Yanzhong Industrial. Therefore, the acquisition has been called the "Baoyan Incident" in China.

[11] World Trade Organization Official Website, "China and the WTO", available at *http://www.wto.org/english/thewto_e/countries_e/china_e.htm* [Accessed 9 September 2021].

[12] Tyrrell Levine and Kim Woodard, "The New Face of Chinese M&A" (2006) 169 *Far Eastern Economic Review* 18.

enterprises to give them more access to public capital.[13] It is likely to spur corporate acquisitions in the country, as the STAR market adopts lax regulatory standards compared with that being applied on the main boards in Shanghai and Shenzhen. The second major reform initiative is about the Shanghai-London Stock Connection (SLSC), an experimental cross-border financial market listing and trading scheme allowing eligible companies in either China or the UK to list or dual-list their shares in the opposite markets (Shanghai Stock Exchange or London Stock Exchange), so Chinese companies will welcome more investors from the UK and the EU, and vice versa.[14] Clearly, the latest SLSC will enhance Shanghai's status as an international financial centre and further stimulates corporate takeover activities in China, since investors in the West can channel their funds into China through the new stock market connect scheme. Therefore, it is high time for the Chinese law-maker and financial authority to explore a more effective and efficient regulatory framework of governing corporate M&A. Compared with the burgeoning and rapidly changing M&A practices in the country, current Chinese legislations in this area seem to be insufficient and less effective in regulating takeover practices. In contrast, the US has been the world's largest M&A market, with relatively extensive laws and regulations governing M&As and rich practice experience in this field.[15] As is known, legal transplantation is the most fertile source of legal development.[16] Therefore, it would be beneficial to study relevant experience of M&A practices in the US to shed some light on China's future corporate law reform.

Against this background, this article discusses and analyses the Chinese takeover law with a particular focus on the director's duty of care under takeover defence. The analysis is made from a comparative law perspective by referring to the US law in the same field,[17] especially the "business judgement rule" which is the basic standard adopted by US judges to examine the behaviours of directors of the target companies in the circumstance of anti-acquisition.[18] In doing so, the article explores the feasibility of introducing the business judgement rule into China based on the evaluation of the country's market reality and unique legal environments. Moreover, the authors try to initiate the academic debate in this area and inspire more legal scholars and practitioners to pay attention to the development of Chinese takeover law. The article proceeds as follows. First we consider the principle and contents of director's duty of care under Chinese corporate law. The next section evaluates

[13] Bloomberg, "China's star board among world's top three IPO venues" (*Bloomberg.com*, 3 August 2020), available at: *http://www.bloomberg.com/news/articles/2020-08-03/china-s-star-board-among-world-s-top-three-ipo-venues-ecm-watch* [Accessed 9 September 2021].

[14] Lerong Lu and Ningyao Ye, "Shanghai-London Stock Connect: Operating Mechanism, Opportunities and Challenges" (2019) 34 *Journal of International Banking and Financial Law* 684.

[15] In 1914, the US Congress set up the Federal Trade Commission and promulgated the Clayton Act, in which the Act prohibited a number of specific business practices that are inimical to the state economy, including anticompetitive acquisitions for the first time. From Debra A. Valentine, "The Evolution of U.S. Merger Law", (1996) *Federal Trade Commission*, available at: *https://www.ftc.gov/public-statements/1996/08/evolution-us-merger-law* [Accessed 9 September 2021].

[16] See Alan Watson, *Legal Transplant: An Approach to Comparative Literature* 2nd edn (Georgia: University of Georgia Press, 1993).

[17] The comparative legal method in this article refers to comparing the law of P.R. of China to that of the US, the basis for comparison is the US takeover-related laws and regulations juxtaposed against the measure of China's relative laws. Edward J. Eberle, "The Method and Role of Comparative Law" (2009) 8 *Washington University Global Studies Law Review* 451.

[18] Bernard S Sharfman, "The Importance of the Business Judgment Rule" (2017)14 *New York University Journal of Law and Business* 27.

director's duty of care in the context of takeover defence. Then we examine China's judicial dilemma in assessing the director's duty of care in acquisition defence. This is followed by a discussion of the US judicial experience of assessing the director's breach of the duty of care under takeover defence. It will review leading case laws in the US covering the reasonableness and adequacy review of takeover defences, the legitimate business purpose review of defence measures, the auction rule, as well as the principle of non-interference with shareholder's basic rights. The next section, then, makes some suggestions for China's future takeover law reform concerning the director's duty of care. The final section draws a conclusion.

The principle and contents of director's duty of care under Chinese law

The origin of director's duty of care

The duty of care constitutes an important part of corporate director's fiduciary duty. Generally speaking, common law jurisdictions such as the US, United Kingdom, Canada, Australia, Hong Kong, and Singapore classify the relationship between directors and companies as the fiduciary relationship, in which the directors are the trustees of the company and therefore, they bear the fiduciary duty to the company.[19] The contents of the fiduciary duty include loyalty and care.[20] The company law in China, despite being a civil law jurisdiction, inherits this view from common law, for the reason that the directors hold enormous power within a company, so they shall assume greater fiduciary duty for the company in proportion to the power they possess.[21] As the operators of a company, directors must ensure the maximisation of the company's interests whilst pursuing their own legitimate interests like receiving salary and bonus payment as the remuneration for the work they are doing. However, when there is an obvious conflict between the two, company directors, as rational economic individuals, are likely to sacrifice the company's benefits for the sake of their own interests.[22] To balance the interests of directors and the company they serve, the key of law-making is to ensure director's interests in most cases align with that of the company and shareholders. If there exists a discrepancy, company law should have procedural rules for the board's exercise of its right as well as for the director's behavioural standards, stipulating that shareholders have the right to make final decisions as beneficiaries. Such fiduciary duties will balance unequal interests between directors and shareholders by mandatory means, so as to protect beneficiaries' interests and confine the expansive rights of the trustees.

The term "trust" is used to describe a fair, kind, and reliable relationship, which is not only a basic requirement of interpersonal communication in human society,

[19] For the discussion of the director's fiduciary duty in the UK, see Paul L. Davies and Sarah Worthington, *Gower's Principles of Modern Company Law*, 10th edn (London: Sweet & Maxwell, 2016), p.485. For director's fiduciary duty in Australia, see Rosemary T. Longford, *Directors' Duties: Principles and Application* (Alexandria: Federation Press, 2014), p.13. For director's fiduciary duty in the US and other jurisdictions, see Andreas Cahn and David C. Donald, *Comparative Company Law: Text and Cases on the Law Governing Corporations in Germany, the UK and the USA* (Cambridge: Cambridge University Press, 2018), p.393.

[20] Cornell Law School Legal Information Institute, "Fiduciary Duty", *Law.cornell.edu*, available at: *https://www.law.cornell.edu/wex/fiduciary_duty* [Accessed 9 September 2021].

[21] Jun Wang, *Corporate Law of China* (Beijing: Higher Education Press, 2015), p.325.

[22] Fang Zhang, *Research on the Legal System of Company Acquisition* (China: Law Press, 1998), p.59.

but the guarantee for efficient and safe transactions among market economic entities as well.[23] Directors, who act as the trustees for a company, have professional knowledge and skills and they shall adhere to strong professionalism and assume strict fiduciary responsibilities with conscience. In this regard, the trustees must treat both moral and legal responsibilities equally, which is the essence of the director's fiduciary duty. Such a corporate law system, based on the mutual trust and a high degree of moral and legal restraints, can be used as a reference point in establishing a sound and comprehensive corporate governance regime in China. Directors' duties should be interpreted from the perspective of personal integrity as well as from the conception of trust. In doing so, directors as trustees are able to discharge their legal obligations by fulfilling the company's social responsibilities and citizenship.[24]

The scope of director's duty of care in China

At present, the regulations on director's diligence obligation in China are scattered around various pieces of parliament legislations, administrative regulations, and departmental rules, for the relevant rules have never been codified into a single piece of legislation.[25] Therefore, it is necessary for us to summarise the current Chinese laws on the director's duty of care, so the director's duty of care can be clearly defined and analysed in the following sections. It also provides readers with a clear understanding of what kind of duties are owed by Chinese directors to their company. However, it should be noted that the Chinese law in this area sometimes lacks clarity, as the wording of legislations are often made in a vague and broad manner. It needs legal practitioners and judges to ascertain the exact meaning and scope of director's duties on a case-by-case basis.

The duty to attend board meetings

The director's duty to attend the board meetings is stipulated in the PRC Company Law 2018 and other legislations, and the duty contains the following specific points: (1) to attend the board meetings; (2) to sign on the board meeting records; (3) to attend the shareholder meetings; and (4) to take responsibility for the resolutions of the board meetings and shareholder meetings.[26] The board meetings play a central role in corporate governance by providing an opportunity for directors to exchange valuable information, resolve difficulties in the business operation, and make vital corporate decisions.[27] The members of the board usually meet monthly or bimonthly, as is outlined in the articles of associations and other bylaws. Regular meeting attendance has been considered a hallmark of a conscientious

[23] For example, the word "trust" means the "firm belief in the reliability, truth, or ability of someone or something; confidence or faith in a person or thing, or in an attribute of a person or thing." from Oxford English Dictionary (*www .oed.com*).

[24] Shaowei Lin, *The Modern Company Law in the UK*, 1st edn (Beijing: China Legal Publishing House, 2015).

[25] The Chinese legislations regarding director's duty of care can be found in four pieces of parliament-made laws: PRC Company Law 2018, PRC Bankruptcy Law 2006, PRC Securities Law 2019 and PRC Enterprise State-Owned Assets Law 2008, as discussed later in the article.

[26] PRC Company Law (2018), art.110; CSRC, the Guidelines for Articles of Association of Listed Companies (2019), art.99; CSRC, the Code of Corporate Governance for listed companies (2018), Chapter 3; CBRC, the Pilot Measures for Evaluating the Performance of Directors of Commercial Banks (2010).

[27] Nikos Vafeas, "Board Meeting Frequency and Firm Performance" (1999) 53 *Journal of Financial Economics* 113.

director, and the failure to attend board meetings tends to signal director's inability or unwillingness to satisfy their fiduciary duty. A previous study also indicated that board attendance could be used as a proxy measure in evaluating the board supervisory quality as the higher board attendance rate improves the financial performance of the company.[28] Therefore, encouraging the active participation of directors in board meetings, including both in-person and virtual meetings, will increase the engagement of the board and thereby contributes to the company's success in fulfilling the corporate objectives.[29]

The duty to disclose information

Detailed regulations on the director's duty of information disclosure can be found in Chapter 5 of the PRC Securities Law 2020 and other legislations.[30] The directors are supposed to disclose the daily activities to the board or shareholder meetings and to disclose essential information to relevant stakeholders in a timely, accurate, complete, and comprehensive manner. It is a basic requirement to ensure the transparency of business decision-making and to address the information asymmetry between the corporate officials and other stakeholders. In case of modern dispersed ownership of the company's shares, the primary justification for director's duty of information disclosure lies in the nature of their fiduciary relationship with the company, whereby shareholders rely on the accurate information given by the directors to monitor their conduct of the business. Therefore, the adequate and timely disclosure of information could protect shareholders from making ignorant decisions which might prejudice their interests in a long term.[31]The disclosure obligation imposed on corporate directors is particularly important when directors are asked to advise shareholders on taking actions by voting or selling shares, for such a request for shareholders' action is likely to affect their basic rights concerning corporate ownership.[32]

In the case of China, this trend has been clearly observed. Although most of Chinese listed companies have a mixed ownership structure having state, legal persons, and individuals as three main types of shareholders, the continuing market-oriented reform has been making the ownership of Chinese listed companies more dispersed.[33] One recent example of the dispersed corporate structure of Chinese state-owned listed company is the well-known ownership "war" between Vanke and Baoneng Group. Vanke, one of the largest private residential real-estate developers in China, was driven to revolt by a high-profile takeover by Baoneng

[28] Ying-Fen Lin, Yaying Mary Chou Yeh and Feng-Ming Yang, "Supervisory Quality of Board and Firm Performance: A Perspective of Board Meeting Attendance" (2014) 25 *Total Quality Management & Business Excellence* 264.

[29] Gene Takagi, "The Importance of Board Meeting Attendance" (*Nonprofit Conversation*, 8 June 2009), available at: *http://nonprofitconversation.blogspot.com/2009/06/importance-of-board-attendance.html* [Accessed on 9 September 2021].

[30] CSRC, Guidelines for Articles of Association of Listed Companies (2019), art.98; CSRC, Administrative Measure for the Disclosure of Information of Listed Companies (2007), arts 3, 12, 15, 23, 38, 39, 40, 42, 44, 58; SSE, Notice of the Shanghai Stock Exchange on Issuing the Measures for Assessment of Listed Companies' Information Disclosure (2015), art.36; Measures for Regulation of Listed Companies Secretaries to the Board of Directors (2015).

[31] See American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations: Proposed Final Draft* (1992), Chapter 3.01.

[32] Nicole M. Kim, "Malone v. Brincat: The Fiduciary Disclosure Duty of Corporate Directors Under Delaware Law" (1999) 74 *Washington Law Review* 1151.

[33] Xiaonian Xu and Yan Wang, "Ownership structure, corporate governance, and firms' performance: The case of Chinese stock companies" (1999) 10 *China Economic Review* 75.

Group. The takeover legal dispute dominated the news headlines for almost three years and the previous state-owned Vanke ended up with Shenzhen Metro becoming its largest shareholder and its previous chairman and the founder Wang Shi's announcement of stepping down.[34] "In China where a well-developed executive labor market has not been established, a professional manager who plays the role of founder in essence represents a highly-specific value to the enterprise," says Prof. Zhang Tianyu from CUHK Business School. Clearly, directors' duty of information disclosure is especially useful in such scenario.[35]

Another aspect of director's duty of disclosure underemphasised under Chinese law is to make clear explanation to shareholders regarding how the board of directors discharge their duties in a way that they reasonably believe to be in the best interest of the company. The idea is enlightened by the UK corporate governance system in which the director's duty to inform is based on a do-it-yourself dimension and is largely voluntary and self-administered.[36] To make the full report on their work, directors need to articulate the decision-making process of the board as well as the strategic rationale behind such decisions. With this "comply or explain" approach of information disclosure, the confrontation between shareholders and directors is minimised and shareholders are capable of making a comprehensive evaluation of corporate governance situations based on the director's competence and independence.[37]

The duty to stay well-informed of the company's management status

Apart from setting the strategic direction of the company, directors should periodically review the business status quo. In this aspect, China has made comprehensive and meticulous legal provisions requiring directors to be serious and cautious about the company's business operation.[38] A diligent director is the one who effectively devotes the necessary time and efforts to performing the tasks on them as a senior officer of the company. The director shall grasp and understand the current management situation in a timely fashion, and they must be held accountable for the failure to understand the company's current situation. Therefore, it is suggested that a periodical strategy review shall be undertaken by the board, which contains a high-level examination of both internal and external elements that could adversely affect the business and management of the company. Regular strategic reviews could assist the board of directors in making sure that the company has the capability of manoeuvring through business uncertainty in the future, instead of simply anticipating minor changes in the current marketplace. This could help directors to keep abreast of the *status quo* of the business management and

[34] Global Times, "Shenzhen Metro Becomes Vanke's Largest Shareholder with 29.38% Shares" (*Globaltimes.cn*, 11 June 2017), available at: *https://www.globaltimes.cn/content/1051064.shtml* [Accessed on 18 June 2021].

[35] An Ran, "The battle of ownership in Chinese enterprises: Vanke" (2017) *CUHK Business School Look Forward*, available at: *https://cbk.bschool.cuhk.edu.hk/the-battle-of-ownership-in-chinese-enterprises-the-case-of-vanke/* [Accessed 18 June 2021].

[36] *U.K. Corporate Governance Code*, Section E: " There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place."

[37] John C. Wilcox, "Comply-and-Explain: Should Directors Have A Duty to Inform" (2011) 74 *Law & Contemporary Problems* 149.

[38] Guidelines for Articles of Association of Listed Companies 2019 art.98; Measures for the Administration of the Takeover of Listed Companies 2007 art.8; Rules Governing the Listing of Stocks on Shanghai Stock Exchange 2013.

promotes the prosperity and long-term growth of the company. In this sense, the duty to stay well-informed of the company's manage status is an effective way to promote the success of the company.

The duty to take due care in business decisions

PRC Company Law 2018 clarifies the powers that belong to the board of directors.[39] In real business practice, most defendants of takeover activities serve as both general manager and executive director at the same time. Thus, one can reasonably infer that the directors have the duty of care to make reasonable and prudent business decisions. Nevertheless, directors, as senior managers, often have to make business decisions fraught with risks. When an urgent business issue comes in front of the board, directors sometimes are not able to take considerable and sufficient time in search of the right options due to the rapid changing business environments and policies in China. Decisions are likely to be made quickly on the basis of the feeling and hunches with limited data, particularly in the large scale and highly diversified business operation of modern corporations.[40] The complexity and diversification of business operation will be further complicated by other daily management problems such as the financial viability, the personnel succession, the market development, and the complex labour relationship. Therefore, the requirement for directors to make business decisions carefully does not necessarily mean that the decision-making process will be faultless. In fact, it is unrealistic to expect that any individuals can be proficient in all aspects of the business operation in any time.

The duty to supervise corporate operation

Since directors are mostly familiar with the current market and operating conditions, their supervision over corporate operation, to a large extent, would be more efficient and focused than that of external supervisors. We have identified a series of regulatory rules and guidance on director's supervisory obligations under Chinese law.[41] The justification for the supervisory function of directors, in particular for the independent directors, lies in the separation of a company's ownership and management. There is a tendency that the equity of modern companies has become more fragmented across the world, as a large number of individual shareholders hold small amount of shares either through direct shareholding or by owning some units in an investment fund which purchases shares in companies. The fragmentation of equity ownership, coupled with the rise of individual and retail investors, has forced many shareholders to delegate their management and supervision rights to the third parties. They are likely to authorise or entrust directors to perform the supervisory function on behalf of those individual shareholders to prevent the oppression by majority shareholders.[42]Apart from the

[39] PRC Company Law 2018 art.46.

[40] Bayless Manning, "The Business Judgment Rule and the Director's Duty of Attention: Time for Reality" (1984) *The Business Lawyer* 1477.

[41] For example, such duty can be found in the Guidelines for Articles of Association of Listed Companies 2019 art.112; and the Pilot Measures for Evaluating the Performance of Directors of Commercial Banks 2010 arts 21, 22 and 24.

[42] Guido Stein and Salvador Plaza, "The Role of the Independent Director in CEO Supervision and Turnover" (2011) *IESE Business Working Paper* 133.

issue of majority oppression, the daily work of chief executive and other senior officers shall be supervised by independent directors who rely on their expert knowledge and strategic vision to contribute to the corporate value. In most cases, independent directors are appointed for their personal characteristics and professional qualities as they are supposed to perform their impartial role without being influenced by other parties within the corporate organisation. Supervision from either ordinary or independent directors, therefore, will contribute to good corporate governance on various fronts.

The duty to comply with laws, administrative regulations, and articles of association

The PRC Company Law 2018 and other administrative regulations have made general provisions regarding the duty of care, providing that directors should not break laws, administrative regulations, and the articles of the company.[43] Such miscellaneous provisions grant the shareholders an autonomous power in supervising director's duty of care which is explicitly stated in the company's articles. However, as a matter of fact, most companies' articles of association are neither specific nor clear when it comes to director's diligence duty in the context of mergers and acquisitions, which indicates that the board's rights shall not be restricted in this case. The absence of explicit expressions in the articles could result in the deprivation of shareholders' rights in the takeover defence activities, which is an alarming issue and will be discussed later in the article.

The special characteristics of director's duty of care under takeover defence

Generally speaking, the director's duty of care is reflected in every aspect of corporate governance. It has been the most fundamental principle for corporate director's professionalism. However, the interpretation of director's duty of care is becoming more complicated when it comes to a tender offer in any takeover defences, because the duty might display different characteristics at different stages of a take-over bid, and the conflicts of interest among different corporate parties and stakeholders are more apparent during the M&A activities.[44] Therefore, this section of the paper will focus on the examination of the particularity of director's duty of care of the target company under takeover defence. It will discuss the conflicts of interest: between the target company and its directors; between the directors and shareholders of the target company; and between the acquirer and the directors of the target company.

[43] PRC Company Law 2018 art.147; Guidelines for Articles of Association of Listed Companies 2019 art.9.

[44] A tender offer refers to a public takeover bid which forms an offer to purchase some or all of shares in a company. In most cases, the offer is made publicly as it will invite shareholders to sell their shares at a specific price and within a specific time window. The asking price is often set at a premium to the share price on the stock market and it is often contingent upon a minimum or maximum number of shares being sold to the bidder.

The conflicts of interest between the target company and its directors

When an acquisition takes place, the corporate internal management structure will undergo substantial changes, for the completion of the takeover is likely to establish a new board for the newly formed entity. As we discussed earlier, modern corporate governance has seen the gradual separation between the business ownership and the control of the company. Under this circumstance, the conflicts of interest between the target company and its directors will inevitably occur. It is because the ultimate purpose of the acquirer is to buy out most equity of the target company so as to achieve the full corporate control. Directors, as the actual controller of the target company, undertake the responsibility of convening the board meeting, evaluating acquisition conditions and plans, and soliciting opinions on the acquisition proposal. However, the directors who are employed by the target company, in most cases, will face unemployment or being removed from their office as well as lose generous financial rewards upon the completion of the acquisition.[45] Even though the directors might be entitled to receive some financial compensation when losing their board seats, the monetary reimbursement is unlikely to cover the full loss of income and other benefits.[46] A study by Coles and Hoi indicated that the target directors will not only lose their current jobs but also face increasing difficulty in obtaining directorships of other companies in the future.[47] For instance, directors in Pennsylvania who retain all anti-takeover provisions of Pennsylvania Senate Bill 1310 are three times less likely to obtain external directorships compared with those who reject all protective provisions under this bill.[48] Due to the concern of losing the board seat and the generous pay package, directors might not have enough incentive to act in the best interests of the company. Therefore, driven by their personal welfare, most directors are less likely to carefully consider if the proposed acquisition is truly conducive to the company's development as well as to the long-term interest of shareholders, which will potentially result in a direct rejection of the proposed take-over plan that is be financially beneficial for the target company. Based on this assumption, it is crucial to have legal constraints in place to avoid the situations where the directors might prioritise their personal interests over that of the company.[49]

The conflicts of interest between directors and shareholders of the target company

Takeover activities will exacerbate the inherent conflicts of interest between directors and shareholders from the same company that is being acquired. It is well recognised that directors are the executors of the resolutions made by the

[45] Yifeng Shen, "The Evolution of Modern Market Theory of Corporate Control: The Theoretical Significance of Anti-takeover Legislation in 35 U.S. States" (2000) 3 *China's Economic Problems* 20.

[46] Jarrad Harford, "Takeover Bids and Target Directors' Incentives: The Impact of A Bid on Directors' wealth and board seats" (2003) 69 *Journal of Financial Economics* 51.

[47] Jeffrey L. Coles and Hoi. Chun-Keung, "New Evidence on the Market for Directors: Board Membership and Pennsylvania Senate Bill 1310" (2003) 58 *Journal of Finance* 197.

[48] Coles and Chun-Keung, "New Evidence on the Market for Directors: Board Membership and Pennsylvania Senate Bill 1310" (2003) 58 *Journal of Finance* 197.

[49] Yong Li and Ruth Aguilera, "Target Director Turnover in Acquisitions: A Conceptual Framework" (2008) 16 *Corporate Governance: An International Review* 492.

shareholder meetings, and directors sometimes could obtain personal financial gains at the expense of shareholders.[50] In the event of corporate acquisition, directors need to report relevant issues and promptly convey information regarding the acquisition to shareholders and offer suggestions to assist shareholders in making the final decision. However, with the dispersed ownership in most public companies, directors' management activities might engage in the self-serving behaviours which are not necessarily for the benefits of the company as a whole. By excising the management power, directors could advance their personal gains rather than maximising the interests of the company and its members. Hence, it is questionable that directors of the target company, in any event, will fully and accurately report the corporate information including its latest financial statements, and some directors, in order to prevent the occurrence of an effective acquisition, might mislead the shareholders to make wrong or biased decisions. This can be done through the partial presentation or deliberate omission of essential information. As we know, the primary role of directors should be the loyal defender of the company's overall interests including some basic shareholder rights. By taking into account the interests of relevant stakeholders, directors as per corporate law in China must act in good faith to maximise corporate benefits and to promote the company's ultimate success.[51] We believe that this should be used as the basic standard for judging if a director violates his or her duty of diligence in the context of acquisition defence.

The conflicts of interest between the acquirer and the directors of the target company

Acquisitions usually happen between two publicly listed companies. Going public can help companies to obtain additional capital and financing resources through a public selling of new shares. Public listing is considered a transparent market transaction by which spare capital in the society will be allocated to where it is needed most.[52] Going public also improves the company's competitiveness and corporate governance through competent financial management, as a public company will be subject to extra securities regulations and disclosure requirements made by the financial authority. Despite the obvious advantages for a company to go public, there are also some disadvantages of being a listed company. For instance, some of the business founders tend to lose control over the operation of the business as more external investors join the company and will have power to vote on corporate decisions and to nominate new directors. Going public also indicates the extra obligations to disclose corporate information required by regulatory authorities. As the subject of financial transactions, corporate equities or shares are essentially a manifestation of the company's collective economic interests reflecting its core value, the operating capability as well as the market sentiment. Clearly, shares of high-quality companies, such as Apple, Amazon, and Tesla, are a scarce resource in the stock market as most retail and institutional

[50] Lucie Courteau, Roberto Di Pietra, Paolo Giudici and Andrea Melis, "The role and effect of controlling shareholders in corporate governance" (2017) 21 *Journal of Management & Governance* 561.
[51] Jun Wang, *Corporate Law of China* (2015), p.352.
[52] Jeffrey Wurgler, "Financial markets and the allocation of capital" (2000) 58 *Journal of Financial Economics* 187.

investors compete to purchase such equities, often at a premium. In a friendly acquisition, the acquirer would normally take the initiative to negotiate with the directors of the target company on the acquisition conditions and the detailed plan of completing the transaction; the directors of the target company would negotiate with the acquirer on the issues like stock prices, and vice versa.[53] On the contrary, a hostile takeover is usually defined as making a tender offer without the permission or support of the target board of directors.[54] Therefore, when facing a hostile takeover, the directors of the target company are expected to take an antagonistic stand, in which they often prevent the implementation of the acquisition by various methods like raising the acquisition cost, increasing the difficulty of the acquisition, or even reducing the attractiveness of the acquisition alike.[55] Some typical defensive measures to be taken by the board of the target company against a hostile takeover include: (a) "golden parachutes", which provides additional compensation for the senior management of the target company and aims to decrease the value of target assets to deter acquisition; (b) "poison pill", which is a distribution plan for shareholders to purchase equities of the target company at a heavily discounted price; and (c) "scorched earth", which refers to a self-tender offer by the target company that burdens the target company with extra debts as it intentionally decreases the desirability of the target company.[56] In essence, the acquisition can be seen as an equity transaction between the acquirer and the target company's shareholders, so it would be inappropriate to distinguish friendly acquisitions from hostile ones by simply considering the target directors' attitudes and ideas. However, such distinction made by directors has been widely accepted in the corporate world, since the interests of directors will be firstly affected when the acquisition activities begin. No matter what happens, directors are always at the heart of conflicting interests during the acquisition process. After analysing the special characteristics of director's duty in takeover activities, the next section will focus on the Chinese laws relating to directors' duty of care under takeover defence, especially the challenges for Chinese courts to enforce laws in this area.

China's judicial difficulty in assessing the breach of director's duty of care under acquisition defence

From what has been analysed, the director's duty of diligence and care is of great importance to the takeover defence. Such duty first appeared in the PRC Company Law 2005 and has been further developed in China's corporate world and judicial practices. However, relevant legal provisions have remained relatively simple and vague, which does not provide adequate legal sources for Chinese courts to deal with the cases. In this section, we will analyse the legal challenges facing China's courts and their judicial practices concerning the director's duty of care in three

[53] David H. Zhu, "Group Polarization on Corporate Boards: Theory and Evidence on Board Decisions About Acquisition Premiums" (2013) 34 *Strategic Management Journal* 800.

[54] CFI, "What is a Hostile Takeover" (*corporatefinanceinstitute.com*), available at: *https://corporatefinanceinstitute.com/resources/knowledge/deals/hostile-takeover/* [Accessed 18 June 2021].

[55] Jing-Xi Liang, "Target Company's Decision-making Right to Anti-Acquisition" (2002) 3 *Academic Exchange* 21.

[56] Dmytro Biryuk, "17 Defenses Against Hostile Takeovers" (*Biryuk Law*, 5 December 2020), available at: *http://www.biryuklaw.com/hostile-takeover-defenses* [Accessed 9 September 2021].

areas, before we turn to the US experience and make suggestions for China's corporate law reform.

The lack of a strong judicial basis for assessing director's duty of care

The Chinese legislations regarding director's duty of care can be found in four pieces of parliament-made laws: PRC Company Law 2018, PRC Bankruptcy Law 2006, PRC Securities Law 2019 and PRC Enterprise State-Owned Assets Law 2008. Besides this, the specific contents of director's duty of care appear in some normative documents such as the Guidelines for Articles of Association of Listed Companies 2019 issued by the China Securities Regulatory Commission (CSRC). There are also scattered provisions relating to the duty in various departmental regulations[57] and administrative documents.[58], and three other pieces of legislations, promulgated by the National People's Congress (NPC) which is the Chinese Parliament, serve as the fundamental legal basis for courts to interpret the scope of director's duty of care, but the concept from the four abovementioned legislations has been described in general terms without detailed explanation of its meaning and applicable situations. Specific explanations of such duty could be found in other departmental regulations but their legal authority is inferior than that of the NPC-made legislations, which is unable to provide clear and authoritative guidance for China's judicial practice. In a word, the general legislative standing of director's duty of care is minimal, so judges are unable to rely on any solid legal basis to make specific assessment when they hear relevant cases.

Apart from the absence of a strong legal basis, there is an imbalance between the interpretations of the duty of loyalty and the duty of care. As mentioned above, the fiduciary duty of directors is deemed a broader concept comprising both the duty of loyalty and the duty of care. While the focus of current legislations is on the duty of loyalty, the latter has not been explicitly defined under Chinese law. The unequal focus between these two competing elements of director's fiduciary duty presents a significant challenge for courts, which might aggravate the agency cost in corporate governance.

The ambiguous definition of duty of care as multiple understandings exist

There is no clear definition regarding the connotation of director's duty of care under Chinese Company Law as it does not specify the detailed conducts for directors. In common law countries like the US, the definition of director's duty

[57] The relevant departmental regulations that regulate directors' duty of care include: CSRC, Administrative Measure for the Disclosure of Information of Listed Companies; CSRC, Measures for the Administration of the Takeover of Listed Companies (2006); CBRC, Regulatory Measures for Professional Qualifications of Directors, Supervisors and Senior Management of Securities Companies; CBRC, Pilot Measure for Evaluating the Performance of Directors of Commercial Banks.

[58] The relevant administrative documents that regulate directors' duty of care include: CSRC, Guidelines for Articles of Association of Listed Companies; CSRC, Guidelines for the Performance of Duties by Independent Directors of Listed Companies; CSRC, Code of Corporate Governance for Listed Companies; SSE, Rules Governing the Listing of Stocks on Shanghai Stock Exchange; SSE, Rules Governing the Listing of Stocks on Shenzhen Stock Exchange; SSE, Model Rules of Procedure for Board of Directors of Listed Companies in Shanghai Stock Exchange; CSRC, Guidance on Independent Directors and External Supervisors of Joint-Stock Commercial Banks.

of care is equally vague, but their judges have developed a series of standards for its interpretation in practice. However, unlike common law jurisdictions where judicial precedents play an important role in shaping the law, China's judicial system lacks the support of case laws and relies mainly on written statues and legal codes.[59] This has presented challenges for Chinese courts to ascertain the exact meaning of director's duty. As discussed, it seems insufficient to merely list the description of director's duty of care in some general clauses[60] in limited regulatory documents dealing with relevant commercial practices.[61] As a result, the concept of the duty of care is constructed vaguely as it lacks suitability and applicability. In most cases, the plaintiff's claims and the courts' judgments simply describe the director's duty of loyalty and diligence as a general concept without mentioning the detailed scope of the duty and in what way such duty has been breached. Furthermore, the duty of care for corporate executives and directors have not been distinguished, as these two roles are supposed to assume divergent duties during the management of corporate affairs.

In China's judicial practice, judges seem to have different understandings towards the connotation of director's duty of care.[62] Some believe that the basic meaning of director's duty of care refers to the principle of utmost good faith. To be more specific, as long as the directors do not act beyond their authority and power to perform duties when a cautious people in a similar position and environment would make the same decision, the directors should not be held accountable for breaching the duty of care. This indicates a relatively low threshold of prove. Other Chinese judges consider that the standard of the director's duty of care lies in whether directors have fulfilled the due diligence obligation in a good manager, as they are supposed to make business judgement decisions prudently and to perform this duty in an active way. There are also judges who equate the meaning of director's duty of care with that similar concept under tort law. In conclusion, due to the inadequacy of relevant legal provisions defining the scope of the duty and the inconsistent judicial standards in practice, it is inevitable that different and even contradictory judgements could be found when courts deal with two similar cases. That is why we call for a more unified and well-defined concept to be made along with a set of application standards for Chinese courts.

The unreasonable design of director accountability rules

At present, company law in China does not stipulate any "safe harbour rules" for corporate directors.[63] In other words, if a director has already complied with the laws, regulations, and the company's articles of associations, but still causes the business to suffer economic or financial losses due to their own mistakes when

[59] Victoria Cromwell, "Common law vs. Civil law: An introduction to the different legal systems" *QLTS* (barbriqlts.com, 1 April 2019), available at *https://barbriqlts.com/common-law-vs-civil-law-an-introduction-to-the-different-legal-systems/* [Accessed 18 June 2021].

[60] CSRC Code of Corporate Governance for Listed Companies in China art.33: "Directors shall faithfully, honestly and diligently perform their duties for the best interests of the company and all the shareholders."

[61] Only the PRC Company Law 2018 Art 151 stipulates the obligation of directors to accept shareholder inquires and cooperate with supervisors (committees) in performing their duties.

[62] See Chinese court verdicts, including Su Zhong Shang Chu Zi No.140, Shen Zhong Fa She Wai Zhong Zi No.36, and Ci Min Er Chu Zi No.519.

[63] The "safe harbour rules" refer to a set of legal provisions to constrain or eliminate legal or regulatory liabilities in certain circumstances, given some pre-defined conditions are fulfilled.

exercising their power and making business decisions, they are likely to be held accountable for the erring behaviours in any circumstances. In this regard, shall we offer certain exemptions for the directors to escape from their personal liabilities? Unfortunately, PRC Company Law 2018 has remained silent on this point as it does not say anything about how to deal with this kind of situation. In contrast, it has given shareholders the right to initiate a derivative action or individual litigation. From this perspective, the law seems not to offer any valid protection for directors, which is not always beneficial for fostering an effective corporate governance regime.

Business environments are always complicated and volatile, especially when a company is facing acquisition. The asymmetry of information and the confidentiality of business operation need directors to make prompt decisions even when the commercial prospect is not entirely clear. Under such circumstance, if directors have to take full personal liability when later on the transaction incurs a loss, it will undoubtedly damage their enthusiasm and enterprising spirit.[64] As a result, this could limit the chance of accepting potentially good business opportunities for the company, which is not conducive to the long-term economic growth. Such an imbalance between directors' rights and responsibilities will undoubtedly create an obstacle for Chinese judges when they determine whether directors shall take responsibilities in specific cases. In this section, we have discussed Chinese judges' difficulty in deciding the breach of director's duty of care in takeover defences, and the next session will evaluate the US experience in dealing with similar situations.

The US experience in judging the breach of director's duty of care under takeover defence

The "business judgment rule" has been developed and tested by US judicial practices over a long period of time. The core of this rule lies in providing a reasonable and appropriate level of protection for directors' management rights and the prevention of excessive judicial intervention in corporate matters. Therefore, the business judgment rule is considered as the "safe harbour" for corporate directors. In this section, we will summarise the specific methods and standards of applying the business judgment rule in US legal practices relating to corporate takeovers. It reviews some leading case laws in the US in relation to the reasonableness and adequacy review of takeover defences, the legitimate business purpose review of defence measures, the auction rule, as well as the principle of non-interference with shareholders' basic rights.

The reasonableness and adequacy review of takeover defences

The reasonableness and adequacy review standard was established in the *Unocal* case for the first time in 1985.[65] Unocal was a well-known oil company. In response to the hostile takeover initiated by Mesa Patroleum, it issued bonds for share

[64] Stuart R. Cohn, "Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule" (1983) 62 *Texas Law Review* 591.

[65] *Unocal Corp. v Mesa Petroleum Co.* 493 A. 2d 946 (Del. 1985).

repurchase, on which basis Mesa alleged that the directors of the target company violated their duty of care and therefore Mesa suffered discriminatory treatment.[66] After the trial, the court ruled that the oil company Unocal won the case by using the rules of business judgment.

In *Unocal*, the acquirer constructed a "two-tier front-loaded" takeover bid to acquire 37% of Unocal's stocks, with the purchase price at $54 per share. The first-tier offer would be paid by cash while the second-tier to be paid in "junk bonds". At the time of the offer being made, Mesa already held 13% of Unocal's shares.[67] The board of Unocal believed that the purchasing price of *Mesa* was too low and suspected the possibility of greenmail fraud.[68] Therefore, to protect the company from this threat, the directors of Unocal initiated a selective exchange offer: when *Mesa* acquired 64 million shares of Unocal, Unocal would repurchase 49% of the company's outstanding shares from shareholders except Mesa, at a price of $72 per share. Obviously, the essence of the selective exchange offer was a poison pill plan and once triggered, Unocal's shares would rise from $54 per share to $72, which would increase the difficulty for Mesa's acquisition. For this reason, *Mesa* filed a lawsuit in the Delaware Court, arguing that Unocal's defensive measures treated the company's shareholders differently and harmed Mesa's interests who was then an existing shareholder. Based on precedents which endorse the application of the business judgment rule in the hostile takeover situations, judges in Delaware Supreme Court believed that Unocal's board of directors had sufficient justifications to reach the conclusion that the purchaser's acquisition would cause damage to the company and therefore, decided that the defensive measures taken by Unocal were appropriate.

The significance of the case is that the judges established "the reasonable and appropriate review standard" here, namely the Unocal Standard. When the target company is at the risk of being acquired, the directors need to ensure that the anti-takeover measures taken will be deemed reasonable and appropriate.[69] In other words, what the board of directors should fight back is an acquisition that would damage the long-term policies and interests of the company and the strength of the counter-attack is "proportional" to the degree of threat facing the target company. According to *Unocal*, in hostile takeover disputes, the *Unocal* test shall be placed before the business judgment rule. Only when the board of directors pass the *Unocal* test could they return to the normal state of default protection under the business judgment rule.[70]

[66] Mark A. Cleaves, "Creeping Federalization of Corporate Law: Unocal Corp. v. Mesa Petroleum Co. and the All-Holders Rule under the Federal Securities Laws" (1987) 12 *Delaware Journal of Corporate Law* 563.

[67] David J. Schubert, "Unocal Corp. v. Mesa Petroleum Co.: A New Era of Fiduciary Duty" (1986) 38 *Baylor Law Review* 687.

[68] Greenmail refers to the practice of purchasing sufficient shares in a company to threaten a hostile takeover so that the target company will instead repurchase its shares at a premium. In M&A, the target company can make a greenmail payment as a defensive measure to stop the takeover bid. The target company has to repurchase the shares at a substantial premium to prevent the takeover, resulting in a substantial profit for the greenmailer.

[69] Anthony J. Dennis, "Assessing the Fallout: Paramount Communications, Inc. v. Time, Inc. and Delaware's Unocal Standard of Review" (1991) 17 *Journal of Corporate Law* 347.

[70] James F. Ritter, "Unocal Corp. v. Mesa Petroleum Co" (1986) 72 *Virginia Law Review* 851.

The legitimate business purpose review of defence measures

In view of the US courts, the legitimacy of defensive measures to prevent acquisitions could also be assessed against the business judgement rule, which was first established in the case of *Moran v Household International Inc.*[71] In this case, the plaintiff claimed that the "flip-in and flip-over" poison pill plan[72] adopted by the defendant was invalid.[73] The poison pill plan was not made to target any ongoing acquisitions, but was an advance defence to deal with any risks of facing potential acquisitions. The court in this case held that: as long as the defensive acquisition is under the scope of the normal business activities and is not simply for maintaining the directors' control over the company, the defensive measure should be protected by the rules of business judgement.[74] The poison pill plan adopted by the defendant was effective for the following two reasons: (1) according to Delaware Corporation Law s.157(a), preferred shares issued by shareholders of the target company's board of directors under the certificate of " right to implement shareholder rights plans" are legal and valid[75]; and (2) the directors of the target company are worried about the risk of potential hostile acquisitions in financing mergers and acquisitions. Accordingly, the reasonable defensive measures taken under such consideration are based on the legitimate business purpose providing that they do not prevent the target company's shareholders from making commitment to the public tender offer, and such measures should be protected by the business judgement rule.[76]

The auction rule

The auction rule was established in the *Revlon* case which is a leveraged buyout case, in which Pantry Pride wanted to dissolve Revlon and sell its assets to achieve the ultimate goal of acquisition.[77] Revlon used share repurchase, poison pill, white knight and other acquisition defence measures correspondingly.[78]It was in this case that the court established the "Auction Rule". In 1986, the CEO of Pantry Pride contacted Revlon's board of directors and proposed a takeover bid to acquire Revlon's shares at a price of $42–45 per share and threatened to take a hostile takeover if necessary. The board of Revlon believes that the acquisition strategy would dismantle Revlon's assets for sale after the acquisition succeeds. Thus, the

[71] *Moran v Household International Inc.*, 500 A.2d 1346 (Del.1985).

[72] The "flip-in and flip-over" poison pill plan in this case refers to a shareholder rights plan. When the acquirer's shareholding in the target company reach a certain triggering point, shareholders of the target company have the right to purchase a certain number of company shares at a discounted price, which will dilute the equity so as to avoid the hostile acquisition.

[73] David S. Newman, "Delaware Serves Shareholders the 'Poison Pill': Moran v. Household International, Inc." (1986) 27 *Boston College Law Review* 641.

[74] Greg C. Ahlum, "Corporate Law-the 'Poison Pill' as a Takeover Defense Tactic-Moran v. Household International, Inc." (1985) 21 *Wake Forest Law Review* 1047.

[75] The State of Delaware General Corporation Law s.157(a): "Subject to any provisions in the certificate of incorporation, every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to acquire from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors."

[76] Ronald David Ellin, "The Poison Pill Warrant-Apothecary and Antidote: Moran v. Household International, Inc." (1986) 36 *DePaul Law Review* 413.

[77] *Revlon Inc. v Macandrews & Forbes Holdings Inc.*, 506 A. 2d 173 (Del.1986).

[78] Kenneth J. Nachbar, "Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.—The Requirement of a Level Playing Frield in Contested Mergers, and its Effect on Lock-Ups and Other Bidding Deterrents" (1987) 12 *Delaware Journal of Corporate Law* 473.

board of Revlon rejected the acquisition request and took some defensive measures immediately, starting from a poison pill plan: if someone purchases 20% of Revlon's shares at a price of less than $65 per share, all Revlon's shareholders other than the purchaser would have the right to subscribe for 12% of convertible bonds with an annual interest rate of $65 per share based on the number of common shares. The plan also stipulates that Revlon's board of directors could redeem the poison pill at a price of 10 cents per right before shareholders exercise their rights.[79] However, the implementation of the poison pill plan did not stop Pantry Pride's increasing purchase of shares in Revlon. When realising the sale of the company was inevitable, the board of directors of Revlon found another buyer—Forstmann Little & Co.—as the "white knight" to join the auction and showed favouritism to it, including making exclusive agreements and providing privileged opportunities and confidential commercial information which had not been given to Pantry Pride.[80] Based on this, the Delaware Supreme Court affirmed the preliminary injunction to bar Revlon from transforming its assets to Forstmann.[81] The court held that the preferential treatments from Revlon's board to Forstmann violated the fiduciary duty of care for not taking the interests of shareholders into account and not maximising the interests of the company by selling the shares at the highest price.

It is apparent that the verdict of Revlon has narrowed the boundaries of what measures that the target company can take to prevent a hostile takeover. The core of the "Auction Rule" is that when the company enters into the sale stage, the primary role of the director has been converted from the company's executive manager to the auctioneer in the selling process. The director is supposed to perform his or her duties as a good auctioneer and strive for the best price for shareholders by contributing to the successful completion of the sale. Therefore, the director is not allowed to take any measures or means that could frustrate the sale.[82] In practice, the "Auction Rule" is also known as "Revlon Obligation".

The principle of non-interference with shareholders' basic rights

The rule not to interfere with shareholders' basic rights like voting rights was established by the Delaware Court in the *Blasius* case, which is viewed as a stricter review standard regarding director's duty of care.[83] The court in this case held that although the directors of the target company claimed to have taken the defensive measures to "compete for a seat on the board of directors", such measures "impeded the exercise of shareholders' voting rights" fundamentally and did not fall within the scope of the company's reasonable normal business activities. Therefore,

[79] The redemption of a poison pill, in this case, means that the board of directors pays 10 cents to a shareholder who has not purchased the convertible bond for $65 and the shareholder no longer has the right to purchase the convertible bond. That is, as long as the poison pill is triggered, shareholders who do not exercise their rights will receive 10 cents each share in return.

[80] Judi G.Sorensen, "Revlon, Inc. v. MacAndrews & (and) Forbes Holdings, Inc. v. Do Suitors of a Target Corporation Have a Right to Compete" (1988) 25 *Idaho Law Review* 441.

[81] The injunction barred: " the consummation of an option granted Forstmann to purchase certain Revlon assets (the lock-up option), a promise by Revlon to deal exclusively with Forstmann in the face of a takeover (the no-shop provision), and the payment of a $25 million cancellation fee to Forstmann if the transaction was aborted." *Revlon*, 506 A.2d at 175.

[82] Peter Cramton and Alan Schwartz, "Using Auction Theory to Inform Takeover Regulation" (1991) 7 *Journal of Law, Economics & Organization* 27.

[83] *Blasius Indus.Inc. v. Atlas Corp.* 564 A. 2d 651 (Del. 1988).

directors could not be exempted from liability by using the business judgement rule.[84] The principle of non-interference with shareholders' voting rights emphasise that if the board of directors' defensive measures prevent shareholders from exercising their voting rights, the directors cannot invoke the business judgement rule to exempt themselves from sensible responsibility.[85] The rule was further extended in the *Liquid Audio* case,[86] in which Liquid Audio added two additional board seats temporarily in order to prevent the director nominated by MM from occupying the board.[87] The US Supreme Court held that the acquisition defence actions by the target company must not undermine corporate democracy. This section has examined key principles of the business judgment rule by referring to leading cases in the US. The next section will provide some suggestions for improving Chinese takeover regulations in the future.

Suggestions for the reform of Chinese takeover law and director's duty of care

As it has been discussed, China does not have a unified set of rules regulating the director's duty of care in takeover activities. Therefore, based on the rich judicial experience in the US, we suggest to introduce the business judgement rule into Chinese takeover law which provides a shelter for director's duty of care, mainly for two reasons. First, a clear guidance of the business judgement rule will ensure the fairness and consistency of courts' judgments and will avoid the courts' arbitrary decisions towards similar cases. Second, it will create a relatively relaxing business decision-making environment so directors are able to make best possible business decisions with creativity and endeavour, which not only promotes shareholders' interests in most cases but also contributes to the overall social-economic development.[88] Accordingly, we make suggestions for the reform of Chinese takeover law in the following four areas.

To define and explicitly explain the scope of business judgement criteria

By referring to the cases and judicial practices in the US, the authors suggest the Chinese law-makers to introduce the strict business judgement rule as follows.

First, when confronting potential acquisition risks, directors of the target company must ensure that the relevant anti-acquisition measures being made in a reasonable and appropriate manner, and accordingly, directors have to satisfy the following three criteria: (1) they need to prove that the offer poses a real and material threat to the company, which is, to prove the urgency and necessity of

[84] David C. McBride and Danielle Gibbs, "Interference with Voting Rights: The Metaphysics of Blasius Industries v. Atlas Corp" (2001) 26 *Delaware Journal of Corporate Law* 927.

[85] Christopher Fawal, "Protecting Shareholder Access to Director Elections: A Response to CA, Inc. v. AFSCME Urging the Adoption of A Blasius Standard of Review for the Exercise of A Fiduciary-Out Clause" (2010) *Duke Law Journal* 1457.

[86] *MM Companies, Inc. v Liquid Audio*, 813 A.2d 1118, 1127 (Del. 2003).

[87] Shaunna L.Wollpert, "MM Companies, Inc. v. Liquid Audio Inc.: Determination of the Review Standard When Directors' Defensive Measure Impedes Shareholders' Right to Vote" (2004) 29 *Delaware Journal of Corporate Law* 175.

[88] David Faure, *China and Capitalism: A History of Business Enterprise in Modern China* (Hong Kong: Hong Kong University Press, 2006).

implementing such acquisition defence actions[89]; (2) if the acquisition defence behaviours meet the urgency requirement, directors have to prove that the proposed actions meet the appropriateness criteria (or the principle of proportionality) which align the severity of the action to that of the threat, meaning that acquisition defence behaviours should not be excessive in any cases[90]; and (3) the company's independent directors should also fulfil their duty of care actively and participate in the company's acquisition defence procedures.[91]

Second, directors of the target company should not use the reverse takeover measures to manipulate the company's operation and undermine the company's democracy; directors should not harm the essential rights, benefits, and interests of the shareholders including their voting rights. It is worth noting that the principle of not interfering with the voting rights of shareholders is better combined with the principle of reasonableness and appropriateness in action based on the decisions from the Delaware Supreme Court in the following ways. First, the reasonableness and adequacy review standards should be employed to make sound business judgements regarding takeover defence measures. On a case-by-case basis, the court has to consider whether the issue of interference with shareholder's voting rights is involved or not. The board of directors of the target company bears the burden of proof for the existence of "unjustified reasons" for the intervention of shareholder voting rights in terms of their acquisition defence measures.[92] Therefore, this principle is complimentary and should be understood as a necessary composition of the abovementioned principle of reasonableness and appropriateness. The two standards do not conflict with each other; instead, both can and shall be used together by courts to measure the appropriateness of the acquisition defence strategy by the target company.

Third, when the company enters into the selling stage, directors of the target company should perform their duties as a good auctioneer and should spare no efforts in securing the best price for shareholders in accordance with the greatest interest of the company to complete the sale successfully. Specifically speaking, this will encompass the following two points: (1) when the company is in the phase of dissolution and liquidation, all the acquisition defensive measures must be stopped; and (2) the role of the directors should change from the "defender" of the company to its "auctioneer" in a timely fashion. The director's duty of care at this stage is to explore the best acquisition plan and to obtain the highest possible premium for the shareholders, which requires directors to remain neutral, to assist the company in completing the merger actively and effectively, and to fulfil the relevant obligations of being an auctioneer.

Fourth, the inversion of the burden of proof should be implemented during the whole process, meaning that directors of the target company must prove that their takeover defence measures fulfil the detailed requirements of their duty of care. Furthermore, it should be made clear that the acquisition defence measures can be

[89] In the *Unocal* case, Mesa's two-tier takeover offer clearly oppresses the shareholders of the target company, which meets the urgency takeover defence requirements.

[90] John H. Matheson and Jon R. Norberg, "Hostile Share Acquisitions and Corporate Governance: A Framework for Evaluating Antitakeover Activities" (1985) 47 *University of Pittsburgh Law Review* 407.

[91] Arthur W. Hahn and Carol B. Manzoni, "The Monitoring Committee and Outside Directors' Evolving Duty of Care" (1977) 9 *Loyola University Chicago Law Journal* 587.

[92] Brian R. Cheffins, "Delaware and the Transformation of Corporate Governance" (2015) 40 *Delaware Journal of Corporate Law* 1.

implemented against both actual and potential acquisition risks. Last but not least, directors have to abide by procedural justice strictly and follow the correct acquisition procedures set by relevant laws, regulations, and administrative measures.

To clarify the applicable conditions of business judgment rule

In light of the US judicial experience, China could incorporate the following provisions into its judicial interpretations. Only when the directors of the target company meet the following conditions will they be protected by the business judgment rule and not be liable for breaching the duty of care: (1) when making decisions, directors must consider the company's overall interest and integrate any acquired information to maximise the interest. The specific criteria of reasonable expectation could be drawn on the objective criteria in the US law, that is, the level of attention which an ordinarily prudent person should have in a similar position and in a similar environment; and (2) directors should act in good faith and take the initiative to avoid conflicts between the personal interest and the company's interest, predict business risks comprehensively with information covering all aspects of acquisition, and put the overall benefits and interest of the company above their personal gains. Regarding the standard's objective or subjective nature, judges should be given the discretion to determine if directors meet the standard of "good faith" based on the conditions of individual cases.

To clarify the application procedures of business judgment rule

It is clear that the inversion of the burden of proof should be applied when applying the business judgment rule, which is, the directors of the target company need to prove that they fulfil their duty of care when implementing the anti-takeover actions. The authors suggest a combination of subjective and objective standards for the level of proof. The objective parameter refers to a "reasonably diligent person" who have common knowledge, skills, and experience and shall reasonably be expected to achieve the same effect as a director, while the subjective standard is based on the actual knowledge, skills, and experience of the particular directors in the case. When the two standards contradict, the authors would recommend the higher one to be adopted. For instance, if the director's own ability is lower than that of a generally and reasonably diligent director, the latter should be used as the criteria for the court's judgment. If the actual ability of the director is higher than that of a reasonable and diligent person, the judgment should be based on the knowledge, skills, and experience that such director actually possesses. The aim of employing this stringent standard is to impose stricter requirements on directors regarding their duty of care, which could be conducive to protecting the company's creditors and other stakeholders. At the same time, judges also need to abide by procedural justice strictly when applying the business judgment rule, so as to avoid blindly or mechanically transplantation of laws and therefore maximise judicial justice.

Other suggestions to help directors better perform the duty of care

The authors believe that by introducing a clearly defined business judgment rule, takeover laws and regulations in China could be significantly improved. It, to some extent, prevents directors from frequently breaching the duty of care and is able to minimise the agency costs. We also make some further suggestions for China's law makers. First of all, the shareholders' right to know must be expanded. One mounting risk facing Chinese shareholders if the country decides to introduce the business judgment results from the relatively poor corporate governance standards in the country compared with the US. There is no distinctive separation of ownership and management rights in most Chinese companies, as the founders of business often exercise absolute control over the business, and the information disclosure procedure between shareholders and directors is not always in place. To tackle the problem of information asymmetry, relevant provisions could be added to the judicial interpretations in terms of giving shareholders a right to appoint verifiers in acquisition defence activities. This could provide a legal basis for shareholders to supervise directors during the acquisition process in case directors' actions infringe shareholders' basic rights and harm the overall interests of the company. Moreover, the authors suggest that a board system with relevant grading and divisions to be implemented in China. Currently, there is no effective liability protection mechanism for directors and as a result, there is no positive incentive for directors to actively exercise their duty of care, which has led to an unreasonable expansion of director's duty of care. As a response, companies could stipulate in their charters that members of the board are divided into equal groups. The board of directors will only select one group each year, and there are only certain directors who will be re-elected when their tenure expires. In this way, the number of the board is stabilised, which alleviates directors' concerns about making business judgment in the acquisition defence and forces directors to exercise their power in the best interests of both the company and its the shareholders.

Conclusion

After four-decade market-oriented economic reforms, China has become the second-largest economy in the world with a robust corporate world and capital markets. The country's economy is still developing at a relatively fast speed and its business environments have been constantly evolving. Takeover activities are the inevitable result of free-market competition, which contributes to the more efficient allocation of capital and corporate resources and it promotes overall economic growth. In this article, we pay attention to the Chinese law dealing with takeover defences, as directors of the target company are called to be particularly diligent in securing the greatest interests for the target company and its shareholders. However, due to the intrinsic conflicts of interest among different parties in any takeover activities, takeover defence behaviours are prone to be exploited by some corporate directors who abuse their power and privilege for personal gains if there is no adequate legislations and a sound supervisory mechanism in place, which is the case in China. The business judgment rule discussed in this article is a set of case law rules for US judges to assess whether directors violate their duty of care.

In detail, the rule covers the principle of reasonableness and adequacy, the review of the legitimate purpose of the defence measures, the auction rule, and the principle of non-interference with shareholders' basic rights. With reference to the precious judicial experience of corporate takeovers in the US, the authors suggest China to explicitly define the scope of the business judgment criteria in its corporate law, and then to clarify the applicable conditions as well as the applicable procedure of the business judgment rule. In doing so, we can ensure the fairness and consistency of the judgment results for takeover defence cases in China, which is conducive to its long-term economic growth and the fostering of world-class corporations in the socialist market economy.