Proceedings of the 2023 International Conference on Management Research and Economic Development
DOI: 10.54254/2754-1169/26/20230598

Deficiencies of the Allocation Mechanism of Target Company's Anti-Acquisition Decision Rights under the Chinese Shareholder Primacy

Yifan Chen[1, a, *]

[1]*Law school, Kunming University of Science and Technology, Wujiaying Street, Kunming, 650504, China*
a. 202010903124@stu.kust.edu.cn
**corresponding author*

Abstract: With the continuous deepening of China's market economy system reform, corporate acquisitions, especially hostile acquisitions, are becoming increasingly popular. Therefore, there is an urgent need for the market to improve the relevant legal provisions for anti-takeover decisions and measures. To begin with, this article takes the allocation of anti-acquisition decision-making right from the perspective of comparative law as an index. Then, it sorts out the decision-making models and related measures of anti-hostile acquisitions. Subsequently, this article takes the equity dispute between China Vanke Co., Ltd. and Baoneng Investment Group Co as a case study, using literature research methods and qualitative analysis methods as the basic research approaches to explore various practical difficulties faced by Chinese companies in anti-hostile acquisitions under the shareholder primacy. This refers to the limitations of the legislative design of the relevant shareholder primacy for Chinese listed companies in the face of hostile acquisitions, which include an analysis of the implementation authority of acquisition defense measures, the responsible parties, and the reasons for the insufficient power of the board in anti-hostile acquisition activities. Ultimately, in order to overcome the above deficiencies, this article proposes suggestions on limiting the power of shareholders' meetings to expand the function of the board, improving the mechanism for the operation of directors' powers and responsibilities, balancing the overall rights and protecting interests of shareholders.

Keywords: anti-acquisition, shareholders primacy, anti-acquisition decision rights

1. Introduction

With the development of China's securities market and the reform of state-owned enterprises, the number of acquisition transactions is expanding, which inevitably raises the issue of the allocation of anti-acquisition decision-making power for Chinese companies under the shareholder meeting dominated model. Since the 1960s, Western countries have been taking legal action against hostile takeovers. However, due to historical and political background reasons, this field gradually began to develop in China in the 1990s. Compared with the United Kingdom and the United States, the lag in legislative time and the lack of hostile takeover cases have led to a lack of foresight in China's laws against hostile takeover, and there is a corresponding lag in system design. Therefore, in the context

DOI: 10.54254/2754-1169/26/20230598

of rapid social development and continuous market expansion, China's current regulations on the obligations of directors are not yet perfect and there is a possibility of abuse, which can easily cause chaos in the control rights of listed companies and the trading market. Meanwhile, China is a socialist country with the particularity of a socialist market economy system, which cannot have the market conditions of dispersed ownership by British and American companies and an extremely free and open market environment [1].Compared with the relatively tolerant attitude of other countries, in China's business ethics, the traditional concept of the civil law system strongly rejects hostile takeovers, which also makes China's current laws and regulations on hostile takeovers focus on strict restrictions. In this policy context, it is unwise to directly transplant foreign company laws. Consequently, this article aims to conduct research on the legal environment and policy factors in China, as well as to analyze the internal business situation and equity setting of typical listed companies through case studies, so as to study the distribution of anti-takeover decision-making power of target companies under the Chinese shareholder primacy.

2. Allocation of Anti-acquisition Decision Power from the Perspective of Comparative Law

2.1. Shareholder Primacy

The UK is a typical representative country of shareholder primacy. From The City Code, it can be seen that the Code clearly grants the decision-making power over anti-takeover to the shareholders of the target company rather than the operators. Irrespective of the object or reason, even where it is alleged that the purpose of adopting antitakeover measures is to seek the maximum interests of shareholders, until approved by the general meeting, the operator of the target company cannot take anti-takeover measures without the authorisation to cancel any potential or existing acquisition behaviour.

Although the Code grants the decision-making power of anti-takeover to the shareholders of the target company and strictly restricts the anti-takeover actions of the company's operators, this does not mean that the operators in the target company are powerless to deal with hostile takeovers. The operator of the target company can state the advantages and disadvantages in the consulting advice provided to shareholders regarding this acquisition offer, and persuade them to refuse the acquisition offer. The operator of the target company can also seek a third party, namely "white knight", to make a competitive acquisition offer to the shareholders of the target company or take preventive anti-takeover measures such as setting "shark repellent" clauses in the company's articles of association in advance.

The advantages of shareholder centrism in the UK's anti-malicious takeover efforts are mainly reflected in the protection of shareholder interests. Firstly, from the perspective of the principle of freedom of business conduct, acquisition activities often lead to an increase in stock prices, and shareholders should have the right to decide to sell their shares without being constrained by directors. Secondly, allowing shareholders to fully choose whether to accept the acquisition offer can motivate the board to prioritize the company's development in order to ensure their position in the company, thereby enhancing their management capabilities and bringing greater benefits to shareholders [2]. Finally, during the acquisition process, the directors of the target company may adopt various means and measures to resist the acquisition in order to maintain their control position and reputation, which may sacrifice the interests of shareholders. From the perspective of protecting shareholder interests, it is reasonable to entrust decision-making power to shareholders.

Nevertheless, shareholder centrism in the UK also has unsatisfactory limitations. Firstly, shareholders have a long cycle and high cost, especially when faced with major issues such as acquisitions, the efficiency and scientificity of decision-making cannot match that of professional management. Secondly, small shareholders have insufficient discourse power, which often makes

DOI: 10.54254/2754-1169/26/20230598

shareholders vulnerable to manipulation in anti-acquisition, becoming a weapon for major shareholders to seek personal gain and harm the interests of other stakeholders. Once again, with the increasing size of the company and the development of the securities trading market, the shares held by these investors are constantly changing. It is not feasible to rely on such an uncertain and highly liquid group to make anti-takeover decisions [3]. Finally, compared to the management, shareholders have little knowledge of the company's information and insufficient motivation to participate. They are often in a passive state in the handling of company affairs, which is not conducive to decision-making on acquisition matters.

2.2. Board Primacy

The United States adopts a board of directors decision-making model in the ownership of anti-takeover decision-making power. According to the *Delaware General Corporation Law*, It is evident that the board decision-making model in the United States essentially grants the target company's management extensive power to take anti-takeover measures.

In the laws of various states in the United States, there has always been a hostile attitude towards hostile takeovers, manifested mainly in legislation that grants the target company's management extensive anti-acquisition rights. However, unrestricted power will inevitably lead to abuse. The legality of the target company's management's anti-acquisition measures depends on the "commercial judgment rules". According to US state legislation, case law, and the 1994 Corporate Governance Principles issued by the US Institute of Law, If the board has reasonable grounds to believe that an anti-staring action is in the best interests of society as a whole, in accordance with the fiduciary obligations, or in order to protect the interests of the stakeholders concerned, the board of the target company has the right to decide to conduct anti-takeover action. For the constraints on anti-takeover behavior, the US model places greater emphasis on the role of judicial review and has developed specific principles for the application of commercial judgment rules in judicial practice in various states, imposing stricter fiduciary obligations on management [4].

The significant advantage of board centrism lies in the fact that the board, as a permanent and specialized organization of a company, possesses modern business operation and management skills, and can better make decisions on major issues such as anti-takeover than ordinary shareholders. Its operational efficiency is significantly higher than that of an unstable shareholders' meeting, so the company will greatly save costs when facing acquisition decisions, especially vulnerable minority shareholders tend to listen to the opinions of the board. Secondly, the board is more able to consider the interests of non-shareholder members. Compared to shareholders who value the potential interests of the company more, management often evaluates the negative impact of the acquisition on employees or other stakeholders, and thus decides whether to accept the acquisition [5].

However, the shortcomings of board centrism that cannot be ignored are mainly manifested in the conflict of interests between directors and the company and the abuse of director power. The separation of ownership and management rights leads to the generation of agency costs. In general, incentive mechanisms align the interests of the company and management. The expansion of a company's business and increase in profitability usually also mean an improvement in the position of management and an increase in revenue. But when a company faces a hostile bid for acquisition, once the acquisition is successful and the company's control is transferred, the original directors are often expelled from the board, thereby losing everything they had. Hence, although a tender offer is indeed beneficial to the company, directors are likely to refuse all offers based on fear of unemployment [6]. Moreover, it is difficult to distinguish whether anti-takeover measures are for the benefit of the company or for the personal interests of directors. Anti-acquisition measures have become a tool in many cases to protect incompetent directors and consolidate their control over the company.

DOI: 10.54254/2754-1169/26/20230598

2.3. Evaluation and Analysis of Two Types of Mode Selection

From the comparison between the UK and the US, there are advantages and disadvantages in the decision-making power issue of taking anti-takeover measures, whether it is completely relying on shareholder decision-making or solely relying on director decision-making. Therefore, the allocation of decision-making power for Chinese target companies should not be mechanically applied to one of the principles but should choose a moderate method. Although there are indeed strong conflicts of interest among the directors of the target company in the company acquisition, completely depriving the decision-making power of the board and absolving the concept of shareholders as the dominant decision-making center makes the board a subordinate executive body of shareholders, which is not the optimal choice. This article believes that stricter supervision standards should be adopted to improve the regulations and supporting measures for the rights, responsibilities, and fiduciary obligations of the board in legislation, such as commercial judgment rules. The rights and responsibilities of the board and shareholders should be clearly defined. In legislation and practice, the powers and responsibilities that the board should be endowed with, responsibilities that should be assumed, and the initiative that should be fully exerted should be gradually implemented [7]. Firstly, it is necessary to ensure that the company's directors have decision-making power over anti-takeover measures. Secondly, shareholders' supervisory rights should be protected, and their voting or share transfer rights should not be restricted by directors. As long as it is accompanied by the supervisory power of shareholders, it can give directors a huge space for anti-acquisition behavior. Additionally, the powers of directors can be restricted through the articles of association. However, when the directors make modifications to the articles of association, they shall not prejudice the voting rights and share transfer rights of shareholders.

To sum up, the decision-making power of shareholders and directors should be judged based on the specific behavior of the company. For example, if anti-takeover is a decision-making matter of the board, which is closely related to the company's operating policies, it should be led by the directors. On the contrary, if anti-takeover falls within the scope of shareholder voting rights and share transfer rights, it should be led by shareholders.

3. The Dilemma of the Shareholder Primacy in Chinese Anti-hostile Acquisition

3.1. The Current Situation of Anti-acquisition Legislation under the Chinese Shareholder Primacy

3.1.1. Company Law

Article 37 of the Chinese Company Law clearly stipulates that shareholders has the right to make resolutions on the merger, division, dissolution, liquidation, or change of company form of the company; According to Article 46, directors only have the power to formulate plans for the amalgamation, division, dissolution or modification of the corporate form of the corporation. From the provisions of the law, it is obvious that in Chinese legislation, the decision-making model for the acquisition rights of companies is based on the principle of priority of shareholders' meetings. Shareholders not only have statutory powers, but also have statutory powers, which involve more extensive content than the board.

3.1.2. Measures for the Administration of Acquisition of Listed Companies

Article 8 of the Acquisition Measures regulates the fiduciary duty of the shareholders of the target company. Moreover, Article 23 mentions the requirements for the scope of objects to be offered by

DOI: 10.54254/2754-1169/26/20230598

the purchaser. Additionally, Article 33 stipulates the limitation of the scope of authority of the company's directors during the offer period. From the above regulations, it is conspicuous that in response to hostile acquisitions, the current legislation has significant limitations on the scope of anti-acquisition measures implemented by the board and the space for emergency anti-acquisition decision-making power, and in practice, the decision-making of the board is indeed limited. However, the law still grants the board appropriate decision-making power within its scope of authority that is not within the prohibited scope, which is why the Vanke board of directors can lead the implementation of the "White Knight" anti-takeover measures in the "Baowan Dispute".

3.2. The Current Situation of Anti-acquisition Practices under Chinese Shareholder Primacy (Taking the Vanke & Baoneng Dispute as an Example)

Since the beginning of 2015, Baoneng Group has regarded Vanke as the target company for acquisition. The advantages of Vanke lie in its stable operation, good profitability, recognized corporate culture and brand effectiveness, and being a large enterprise group with dispersed shares. Simultaneously, the company's articles of association do not design relevant anti-acquisition protection systems.

Accordingly, in January 2015, Qianhai Life Insurance and Shenzhen Jushenghua Co., Ltd, subsidiaries of Baoneng Group, began to purchase Vanke shares. Subsequently, Baoneng increased its holdings of Vanke shares on July 10 and August 26 of the same year, respectively. As a result, its equity ratio increased from 5% to 15.04%, becoming the largest shareholder of Vanke. On September 1st of the same year, as the original largest shareholder of Vanke, China Resources regained its position as the major shareholder with a 15.23% equity ratio. Baoneng continued to increase its shareholding in the second round, and on December 15th, its equity ratio rose to 23.52%, once again becoming the largest shareholder of Vanke and attempting to take over the board of Vanke. As of August 9, 2016, Baoneng Group has continuously increased its holdings of Vanke A-shares in the secondary market, accounting for approximately 25.40% of Vanke's total share capital, firmly ranking as the largest shareholder of Vanke [8]. In the second stage of Baoneng's significant increase in Vanke's stock holdings, China Resources' neutral and indifferent attitude of ignoring Vanke's management's request for help was questioned by Vanke's management and the public.

Thus, in response to this situation, on the evening of January 12, 2017, Vanke found a strong presence of state-owned assets and introduced the White Knight-Shenzhen Metro Group. Shenzhen Metro took over Vanke's equity held by China Resources, replacing Baoneng as the largest shareholder. On June 30 of the same year, shareholders of Vanke came to an end, and the original chairman was no longer appointed. Baoneng was not selected for the board, and the directors nominated by Shenzhen Railway were elected with a high vote of over 90%.

3.3. Analysis of the Defects in the Anti-acquisition Process under the Chinese Shareholder Primacy

This event is undoubtedly a landmark case in the study of hostile acquisitions. And from this case, it’s apparent that the problems under the Chinese shareholder primacy can also be glimpsed.

3.3.1. The Decision-making Mechanism for Anti-takeover is not Clear Enough, and the Legislative Progress Seriously Lags behind the Needs of Practice

At present, China has the "Management Measures for the Acquisition of Listed Companies" as a legal normative document specifically regulating acquisition behavior. However, from the

DOI: 10.54254/2754-1169/26/20230598

perspective of legal effectiveness level, it is only a normative document at the level of departmental regulations, with a lower level of effectiveness. Therefore, in order to standardize the current legislation on acquisition and anti-acquisition, and end the fragmented situation of legislation, a unified Enterprise Merger and Acquisition Law should be introduced to clearly regulate the acquisition and anti-acquisition behavior of listed companies [9]. Moreover, the legal system of Chinese companies does not provide a clear definition of the concept of "anti-acquisition", which leads to a lack of clear legal basis for actions in practice. Practitioners do not know the tolerance limits of the law, and administrative regulatory bodies are also difficult to grasp the law enforcement standards, because administrative regulations in the field of supervision are also severely lacking.

3.3.2. Insufficient Legal Protection for the Rights and Interests of the board and Minority Shareholders of Listed Companies

The current laws in China grant limited powers to the board, and the regulations on their obligations and responsibilities are not perfect enough, which can easily lead to strong conflicts of interest. The lack of regulations on the powers and responsibilities of the board and the virtualization of their role in practice, coupled with unclear division and definition of power between shareholders and the board, and information asymmetry, make it difficult for the board to fully exert the initiative that they should have in anti-hostile acquisitions [10], given that their professional knowledge is superior to that of shareholders.

And when controlling shareholders or management decide to take anti-takeover measures, there are a large number of small and medium-sized shareholders with dispersed equity, and they do not have much say in anti-takeover implementation decisions. Therefore, even if they think it is unfavorable to them, small and medium-sized shareholders can only drift with the tide and are difficult to stop. The current overall legislative system on anti-takeover in China is in a state of chaos, decentralization, and scarcity, making it difficult to establish comprehensive and effective regulations on anti-takeover. Based on this, it is even more inadequate to protect the legitimate rights and interests of small and medium-sized shareholders in anti-takeover.

3.3.3. Directors' Faithful and Diligent Obligations Have not Developed

The current Company Law of China generally stipulates in Article 147 that directors, supervisors, and senior management personnel have the obligation of loyalty and diligence towards the company. However, in judicial practice, there are difficulties in determining whether a director's behavior constitutes a violation of the above-mentioned obligations due to the lack of clear connotations of loyalty and diligence obligations in the law and only the principal provisions for diligence obligations.

3.3.4. Lack of Voting Decision-making Mechanism Based on Rational Design

The relevant legal norms in China have clear and detailed institutional arrangements for personnel structure, leadership structure, organizational structure, and knowledge structure, and the operation process is basically based on voting, resulting in only two extremes of decision-making and process. However, there is a lack of rules based on rational design such as director equality and collective deliberation, making the board a voting tool in this mechanism, And the process of board meetings has become ceremonial [11].

DOI: 10.54254/2754-1169/26/20230598

4. The Improving Suggestions of the Shareholder Primacy in Anti-hostile Takeover

4.1. Restrict the Power of Shareholders' Meetings and Ensure the Decision-making Power of the board within a Certain Scope

At present, the specific powers that the board should have been not implemented within the scope of China's legislation, which may result in formal empowerment and substantial loss of the essential functions of the board and the role of the board in balancing and supervising the power of controlling shareholders.

Therefore, this reality determines that in the process of anti-hostile acquisitions in China, the board should have the right to propose, and shareholders should decide whether to take anti-acquisition measures, without completely prohibiting them. Even in legislation, the scope of powers and responsibilities that the board should enjoy should be implemented, the relationship between shareholders, the board, and the supervisory board should be properly handled [12], and the balance of power within the company should be improved. An optimized balance point should be sought to enable the board to maximize the interests of the company and shareholders through legitimate risky transactions, in order to develop a more ideal corporate governance decision-making system. Secondly, legislation should specify and clarify the scope of certain acquisition defense measures that the board can implement in the process of anti-hostile acquisitions.

4.2. Attach Importance to the Independent Director System and Improve the Mechanism for Operating the Powers and Responsibilities of Directors

The independent director system is an important component of internal supervision and governance in a company. It is conducive to preventing directors from damaging the legitimate rights and interests of the company and shareholders for their own interests and has a supervisory role in the daily operation and management of the company's management. The main functions of establishing independent directors in the organizational structure of listed companies are twofold. On the one hand, independent directors participate in the daily management decisions of the company, ensuring the fairness of company decisions, and safeguarding the interests of small and medium-sized shareholders from infringement; On the other hand, the important role of independent directors lies in supervision. In the battle for control of the target company, the original shareholders and management of the company may make subjective judgments in order to maintain their own interests, and ultimately take actions that are detrimental to the long-term development of the company. At this time, the existence of independent directors is particularly important [13].

However, throughout the introduction of the independent director system in China to this day, the role of independent directors in company management has been minimal. Some listed companies have set up independent directors in their organizational structures, only treating them as part of the complete company structure without giving them sufficient attention. The importance of independent directors in corporate governance lies in their supervisory function. As a third party outside of company ownership and management rights, their fair position is conducive to balancing many conflicts of interest in listed companies and forming a balance between shareholders and company executives.

4.3. Standardize the Anti-takeover Measures of Listed Companies, Balance and Protect the Overall Rights and Interests of Shareholders

From the perspective of supervision over the target company, although the board should allow the

DOI: 10.54254/2754-1169/26/20230598

right to take anti-takeover measures within a certain range, it is more important to prevent management from using control defense as a pretext to encroach on shareholder interests, damage control and market vitality, and weaken the efficiency of capital market resource allocation. Listed companies are motivated to collude with information media when facing malicious acquisition pressure, which is likely to lead to stock price fluctuations and cause market overreaction, thereby harming the interests of investors. At present, China provides listed companies with greater flexibility in the setting of anti-takeover clauses in their articles of association, and in the future, classified supervision is needed on this issue [14].

In addition, there are many shareholders in listed companies who make slow and difficult decisions, and shareholderss become empty. The various rights, remedies, and awareness of rights protection of small and medium-sized shareholders are often overlooked. Hence, China can refer to Article 228 of the Delaware Company Law of the United States, which stipulates that as long as the shares held by shareholders with written consent meet the requirements for statutory shares at shareholders, resolutions made through written consent and voting at the meeting have equal effect.

5. Conclusion

In order to maximize the overall interests of the target company in the event of a malicious acquisition, the power distribution model of the Chinese shareholders' meeting and board of directors should also be adjusted accordingly. The power of shareholders should be strictly limited to the selection of managers and supervisors, the determination of their salary plans and other related personnel appointment and removal powers, as well as the approval power for structural changes such as articles of association modification, major asset restructuring, and termination. These matters have a significant impact on the company's operation and survival, so they should be made by shareholders through democratic procedures. All powers other than these matters should belong to the independent exercise of the board, so that the board can relatively freely formulate the company's development strategy and efficiently and reasonably utilize the company's resources in the face of fierce commercial competition. In short, under the current law, the majority of the important operational decision-making power belonging to shareholders should be entrusted to the board for decision-making, which should be more conducive to achieving the best interests of the company. Futhermore, in order to increase the supervision and protection of directors' power, it is necessary to draw on the assistance of business judgment rules, and effectively reduce agency costs by strengthening the mechanism of directors' fiduciary obligation constraints, effectively achieving a balance between power empowerment and responsibility constraints.

References

[1] *Lin Shufang. (2012) The development of hostile takeover in China from a legal perspective. Fudan University, 9-10.*
[2] *Zhao,Y. (2009) Debate on Modern American Corporate Governance Theory of Board Centered Theory and Shareholder Centered Theory. Journal of Comparative Law, 4,96-97.*
[3] *Su,L. (2018) Research on Legal issues of ownership of anti-takeover decision-making Right of Listed companies. Fuzhou University,33-34.*
[4] *Catan, E.,Kahan,M. (2015) The Law and Finance of Anti-Takeover Statutes.SSRN Electronic Journal, 68(3),629-630.*
[5] *Petrin, M.,Moore,M. (2017) Corporate Governance: Law, Regulation and Theory. Palgrave Macmillan,289-290.*
[6] *Zeng,Q.Y. (2012) Ownership of the Decision of Anti-takeover Decision of the Target Company. Journal of Jurisprudence,6-7.*
[7] *Zheng,J.N. (2014) Research on the Fidelity Obligation of Target Company Directors in Company Acquisitions. Journal of China University of Political Science and Law, 44 (06),88-89.*
[8] *Feng,J. (2016) The Limitations of Shareholder Centered Theory from the Perspective of the 'Wanbao Dispute'. Huazhong University of Science and Technology, 20-24.*

DOI: 10.54254/2754-1169/26/20230598

[9] He Shucen. (2018) The Dilemma and Overcoming of shareholders Dominant Model in Anti-hostile acquisitions. Hunan Normal University,32-33.

[10] Zeng,X.S. (2022) The Dilemma and Countermeasures of Director Responsibility Regulation: From the Perspective of Individual Differences in Directors. Journal of Law,43(06):102-116.

[11] Wang,C.B (2012) On the Improvement of the Anti-Takeover Legal System of Listed Companies in China. Northeastern University of Finance and Economics,29-30.

[12] Easterbrooke, F.H., Fische.D.R. (2011) The Economic Structure of Corporate Law. Cambridge University Press,163-164.

[13] Liu,G.X., Wang,B.Q., Wang,B.P. (2014) Research on the Factors Influencing the Independence of Independent Directors and Governance Effectiveness:Evidence Based on Board Voting. Scientific Decision Making, 98(01),15-26.

[14] Li,D.F. (2013) On the Supervision Law of Listed Companies.China University of Political Science and Law Press, 307.