German and East Asian Perspectives on Corporate and Capital Market Law: Investors versus Companies

Edited by
HOLGER FLEISCHER, HIDEKI KANDA,
KON SIK KIM and PETER MÜLBERT

Max-Planck-Institut
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Beiträge zum ausländischen
und internationalen Privatrecht
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Mohr Siebeck

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Preface

This volume is based on presentations delivered at a symposium held in 2017 at Seoul National University. It follows two earlier conferences in Hamburg and Tokyo. A fourth conference has subsequently taken place in Beijing in 2018. These four symposia have not only given enormous pleasure to all participants but also stimulated comparative legal exchange between company law academics in Germany, China, Japan and South Korea and put it on a new footing.

We would like to express our gratitude to our South Korean hosts for unforgettable days in Seoul. Furthermore, we would like to thank all speakers for their valuable and much appreciated contributions. Janina Jentz and Yannick Chatard took care of the editing process and their help is gratefully acknowledged. Last, but not least, our sincere thanks go to Michael Friedman and Jane Yager for providing valuable language editing.

Hamburg, Tokyo, Seoul and Mainz
October 2019

Holger Fleischer
Hideki Kanda
Kon Sik Kim
Peter Mülbert

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III. Takeovers in General

Abbreviations

AEA	Act on External Audit of Joint Stock Corporations
AGM	Annual General Meeting
aka	also known as
AktG	Stock Corporation Act (Aktiengesetz von 1965)
Art.	Article
BGH	Germany's Federal Court of Justice (Bundesgerichtshof)
BGHZ	Decisions of the German Supreme Court in civil matters E (ntscheidungen des Bundesgerichtshofs in Zivilsachen)
BaFin	Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht)
BAG	Federal Labor Act (Bundesarbeitsgesetz)
CALS	Centre for Asian Legal Studies of NUS Law
CEO	Chief Executive Officer
CEPS	Centre for European Policy Studies
CFD	Contracts for Difference
C.F.R.	Code of Federal Regulations
CMA	Korean Capital Market Law
Co.	Company
Co. Ltd.	Company Limited by shares
CSD	Central Securities Depository
CSRC	China Securities Regulatory Commission
Del. Ch.	Delaware Court of Chancery
ECFR	European Company and Financial Law Review
ECGI	European Corporate Governance Institute
ECJ	European Court of Justice
ed.	Edition
EDC	Economy Democratization Committee
EEA	European Economic Area
e.g.	for example
ESMA	European Securities and Markets Authority
et al.	et alii/aliae/alia
etc.	et cetera
EU	European Union
FATF	Financial Action Task Force
FinfraG	Financial Market Infrastructure Act (Finanzmarktinfrastrukturgesetz)
FSC	Financial Services Commission
FSCMA	Financial Investment Services and Capital Markets Act

FSS	Financial Supervisory Service
Fund Corporation	China Securities Investor Protection Fund Corporation
GDP	Gross Domestic Product
GmbH	Private limited company (Gesellschaft mit beschränkter Haftung)
GMS	General Meeting of Shareholders
GWG	Money Laundering Act (Geldwäschegesetz)
HC	Halla Construction
HGB	Commercial code (Handelsgesetzbuch)
i.e.	id est
id.	idem
IMF	International Monetary Fund
Inc.	Incorporation
IPC	Institution of Public Character
ISMR	Information Session for Major Restructuring
JASDAQ	Japan Association of Securities Dealers Automated Quotations
KCC	Korean Commercial Code
KCML	Korean Capital Market Law
KFTC	Korea Fair Trading Committee
KOSDAQ	Korea Securities Dealers Association Automated Quotations
KOSPI	Korea Composite Stock Price Index
KRX	Korea Exchange
KWG	Banking Act (Gesetz über das Kreditwesen, Kreditwesengesetz)
LLC	Limited Liability Company
LLP	Limited Liability Partnership
LSE	London Stock Exchange
M&A	mergers and acquisitions
MAD	Directive on Market Abuse
MAR	Market Abuse Regulation
MBR	Mandatory Bid Rule
MSI	Medium and Small Investors
MSI Center	China Securities Investor Services Center
NASDAQ	National Association of Securities Dealers Automated Quotations
NBS	Nippon Broadcasting System
no.	Number
NPA	National Pension Act
NPCSC	Standing Committee of the National People’s Congress
NPS	National Pension Service
NSWLR	New South Western Law Review
NUS Law	National University of Singapore, Faculty of Law
NY	New York
NZG	New Journal for Corporate Law (Neue Zeitschrift für Gesellschaftsrecht)

OLG	Higher Regional Court (Oberlandesgericht)
OTC	Over the Counter
para.	Paragraph
PBR	Price Book Value Ratio
PC	Personal Computer
PRP	Pre-warning rights plan
PSPD	People's Solidarity for Participatory Democracy
PTS	Proprietary Trading System
R&D	Research and Development
ROA	Return on assets
S&P 1500	Standard & Poor's Composite 1500 Index
SA	Société Anonyme
SCA	Stock Corporation Act (Aktiengesetz, AktG)
Sc.L.R.	Scottish Law Review
SEC	US Securities and Exchange Commission
sec.	Section
SIAS	Securities Investor Association in Singapore
SISI	Special Information Session for Investors
SMP	Standard Market Price
SOE	State-owned Enterprise
STA	Securities Transaction Act
TD	Transparency Directive
TOD	EU Takeover Directive
ToSTNeT	Tokyo Stock Exchange Trading NeTwork
TRS	Total Return Swap
UK	United Kingdom
US	United States of America
WpHG or STA	Securities Trading Act (Gesetz über den Wertpapierhandel, Wertpapierhandelsgesetz)
WpPG	Securities Prospectus Act (Wertpapierprospektgesetz)
WpÜG	Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz)

I. Shareholder Activism

Shareholder Activism in Germany

Andreas Engert

I. Introduction

Shareholder activism has become a lasting force in corporate governance around the globe.[1] Hailed by some as a cure for shareholder apathy,[2] others perceive it as a threat to the long-term thriving of corporations and their stakeholders.[3] In Germany, shareholder activism arrived most visibly with the campaign of several UK and US hedge funds, led by The Children's Investment Fund (TCI), against the attempted takeover of London Stock Exchange by Deutsche Börse in 2005.[4] The clash between Deutsche Börse's manage-

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[1] See M. BECHT/J. FRANKS/J. GRANT/H. WAGNER, Returns to Hedge Fund Activism: An International Study, The Review of Financial Studies30 (2017) 2933, 2953 (documenting the rise in numbers of activist campaigns in a broad international sample 2000–2010).

[2] Vocal proponents in U.S. literature include: R. GILSON/J. GORDON, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, Columbia Law Review 113 (2013) 863, 896–902 (characterizing activists as filling the gap left by more diversified institutional investors); L. BEBCHUK/A. COHEN/S. HIRST, The Agency Problems of Institutional Investors, Journal of Economic Perspectives 31 (2017) 89, 104–107 (likewise).

[3] See L. STRINE, Who Bleeds When the Wolves Bite?, Yale Law Journal 126 (2017) 1870; J. COFFEE, The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality, ECGI Law Working Paper 373, 2017.

ment and the activists culminated in the crushing defeat and ouster of the company's CEO Werner Seifert. This very prominent occurrence has been preceded and – even more so – followed by many activist campaigns,[5] prompting many contributions in legal literature, especially by legal advisers of potential target corporations.[6]

Without giving away too much, shareholder activism is now a firmly established part of the corporate governance landscape of German stock corporations.[7] As understood in this essay, it reflects a coherent and specific investment strategy. Briefly put, activism consists of taking significant minority positions in publicly traded firms, effecting changes in corporate management, and selling at a profit. While this is a straightforward description, it fails to cover behaviors that occasionally are also referred to as "activism." Sometimes any sustained exercise of voice by shareholders in the corporation is referred to as "activist." The assertive and short-run campaigns considered in this essay could then be characterized – based on their typical promotors – as "hedge fund activism" to distinguish them from the continuous and more temperate engagement of mutual funds, pension funds, and other traditional institutional investors with corporate management.[8] Hedge funds are also targeting corporations with short selling positions to benefit from alleged – and often real – managerial misbehavior, especially relating to questionable accounting.[9] Likely because of

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[4] BECHT/FRANKS/GRANT/WAGNER, *supra* note 1, 2941–2944 (providing a sketch of the incident); one of the first contributions to the legal debate in Germany was motivated by the Deutsche Börse case, see A. ENGERT, Hedgefonds als aktivistische Aktionäre, Zeitschrift für Wirtschaftsrecht 2006, 2105.

[5] See the studies cited in note 41 *infra.*

[6] See, e.g., M. SCHOCKENHOFF, Vorstände im Visier aktivistischer Aktionäre. Auswechslung und Vergütungsreduzierung auf Verlangen von Aktionären und Investoren?, Zeitschrift für Wirtschaftsrecht 2017, 1785; M. SCHOCKENHOFF/J. CULMANN, Shareholder Activism in Deutschland, Zeitschrift für Wirtschaftsrecht 2015, 297 (citing three cases, including the 1990s "Girmes" case); B. GRASSL/T. NIKOLEYCZIK, Shareholder Activism und Investor Activism, Die Aktiengesellschaft 2017, 49; M. SCHIESSL, Empfehlungen an Publikumsgesellschaften für den Umgang mit Hedgefonds, Zeitschrift für Wirtschaftsrecht 2009, 689, 690–691 (recounting prominent cases and citing Hermann Krages as a German shareholder activist of the 1950s).

[7] See the illuminating comparison between activism in the U.S. and in Germany by K. LANGENBUCHER, Hedge Fund Activism in Germany and the US – on Convergence, Differences and Normative Reasoning, in: Siekmann (ed.), Festschrift für Theodor Baums (Tübingen 2017) 743.

[8] See, e.g., M. DENES/J. KARPOFF/V. MCWILLIAMS, Thirty years of shareholder activism: A survey of empirical research, Journal of Corporate Finance 44 (2017) 405, 407–408 (distinguishing hedge fund activism from other types).

[9] For examples from Germany, see M. SCHOCKENHOFF/J. CULMANN, Rechtsschutz gegen Leerverkäufer, Die Aktiengesellschaft 2016, 517, 518–519; see also J. WENTZ, Shortseller-Attacken – ökonomische und juristische Bewertung eines ambivalenten Geschäftsmodelles,

their public attacks on firms, these hedge funds are also often labeled as "activist."[10] But short sellers only seek to persuade the market of the perceived wrongdoing and to gain from the resulting fall in the stock price. Their strategy does not involve active intervention in the management of the corporation.

The following Section II casts more light on German-style shareholder activism using the recent example of the successful campaign against the incumbent management of Stada AG. It also reviews the empirical evidence on the scope and effects of activism, putting the focus on Germany. Sections III and IV then consider in more depth the issues raised by shareholder activism under German law, separately for the two stages of building a shareholding in the target corporation and then of using the resulting power to influence management. Section V briefly concludes.

II. Shareholder Activism in Germany: State of Play

In this essay, activism is seen as an investment strategy aiming at returns from accomplishing major changes in the management of individual corporations. Dedicated activists specialize in this strategy. Rather than holding a broad portfolio of shares and earning the market return, plus perhaps a minor extra reward for stock picking, activists seek to identify target firms where they believe that implementing far-reaching changes – such as replacing existing leadership or a sale of the business – would substantially increase the market value of the corporate stock. Having found a suitable target, they make concentrated investments at the current price and use the acquired shareholding to pressure for the desired measures. If the campaign succeeds, they liquidate their stake and realize the resulting price increase. The returns of activists reflect mostly their ability to discover worthwhile targets and to pressure their management; the general market return from holding risky stock is only an accidental complement. In the jargon of financial investment, the expected returns consist of much "alpha" (asset manager ability) and only little "beta" (market risk premium). This return composition makes activism the natural domain of hedge funds.[11]

1. Activism as an Investment Strategy: The Case of Stada Arzneimittel AG

The recent activist campaign targeted at the German drug maker Stada Arzneimittel AG ("Stada") serves to illustrate the three steps of buying low, intervening, and selling high. Founded in 1895 as an association of German pharmacists, Stada became a stock corporation in 1970 and went public in

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Zeitschrift für Wirtschafts- und Bankrecht 2019, 196. For the U.S., see I. APPEL/J. BULKA/V. FOS, Active Short Selling by Hedge Funds, ECGI Finance Working Paper 609/2019.

[10] See, e.g., WENTZ, *supra* note 9, 196 ("Shortseller-Attacken").

[11] See *infra* note 40.

1997/1998.[12] Since 1993, the dominant figure in the firm's management had been Hartmut Retzlaff as chairman of the executive board *(Vorstand).* Mr. Retzlaff in 2014 boasted an annual compensation of seven million Euros, a rather large paycheck for a firm with both sales and a market capitalization of around two billion Euros.[13] There were also allegations of Mr. Retzlaff improperly promoting the career of his son within Stada.[14] Perhaps more importantly, the generic pharmaceutical industry had seen much consolidation in previous years. Stada was seen as a potential takeover candidate,[15] except for the fact that the transferability of its shares was restricted, meaning that acquiring them required approval by the executive board.[16]

On 1 April 2016, the investment fund Active Ownership Capital, based in Luxembourg and managed in Frankfurt by two finance professionals,[17] reported having acquired a 5.05% shareholding in Stada.[18] Only as late as 28 June 2016, already deep into the battle, the U.S.-based activist investor Guy Wyser-Pratt announced that he had also acquired slightly less than 3% of the voting rights.[19]

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[12] Until 1997, share ownership had been restricted to pharmacists and physicians. See STADA ARZNEIMITTEL AG, Eine Zeitreise: Die Geschichte von STADA 1895–2015, available at <https://www.stada.de/konzern/unternehmensgeschichte.html> (last visited 1 November 2018); Hoppenstedt Aktienführer 1976–2015, database available at <https://digi.bib.uni-mannheim.de/aktienf%c3%bchrer/data/index.php> (last visited 1 November 2018).

[13] See Stada, Annual Report 2014, pp. 2, 96. In fairness, Mr. Retzlaff in the same year agreed to forego 17 million Euros of his previous 35 million Euros net worth of pension benefits, see Stada, Annual Report 2013, p. 97. Mr. Retzlaff's compensation for 2015, his last full year in office, halved to 3.6 million Euros, Stada, Annual Report 2015, 108.

[14] P. HOLLSTEIN, System Retzlaff: Family Business, apotheke adhoc, available at <https://www.apotheke-adhoc.de/nachrichten/detail/markt/stada-family-business-generika-apotheke-retzlaff/> (last visited 1 November 2018).

[15] See E. HENNING, Activist Investor to Pressure Stada AG to Explore Potential Sale, Wall Street Journal, 3 May 2016, available at <https://www.wsj.com> (last visited 2 November 2018); E. HENNING, Stada Arzneimittel Holds Buyout Talks With CVC Capital, Wall Street Journal, 25 May 2016, available at <https://www.wsj.com> (last visited 2 November 2018) (pointing to estimates of a potential takeover valuation of 60 Euros per share).

[16] § 8 of Stada's articles of incorporation as of 2015, accessible at <https://www.unternehmensregister.de> (last visited 1 November 2018); Stada, Annual Report 2015, 142. Since 1990, stock exchanges no longer require that listed firms commit to granting approval, see W. BAYER, in: Münchener Kommentar zum AktG (4th ed., Munich 2016) § 68 AktG paras. 78–80.

[17] See <http://activeownershipcapital.com> (last visited 19 March 2019). One of the founders, Klaus Röhrig, formerly worked for Elliott, the famous U.S.-based activist hedge fund manager.

[18] Major shareholding disclosures by Stada, accessible at <https://www.unternehmensregister.de> (last visited 19 March 2019). In addition to the shares, Active Ownership Management also acquired call and put options, each for .96% of Stada's shares.

[19] See S. IWERSEN/M. TEIGHEDER, Activist Investor Buys Stake in Stada, 28 June 2016, available at <https://www.handelsblatt.com/> (last visited 19 March 2019).

Other than these two investors, no further changes in Stada's ownership structure became publicly observable.[20] Active Ownership Capital seems to have reached out to other activists as potential allies but without tangible results.[21] Nonetheless, the fund proved capable of launching an ultimately successful campaign against the incumbent management. From the beginning, it appears that Active Ownership sought not so much to mend Stada's strategy or corporate governance but rather to accomplish a sale of the company.[22] Stada's management at one point agreed to nominate five directors suggested by the fund for election to the supervisory board but then reneged on its promise and postponed the general meeting.[23] Mr. Retzlaff appears to have held talks with CVC Capital Partners, a private equity fund manager, as a potential friendly acquirer.[24] When the attempt failed, Mr. Retzlaff cited health reasons for taking an indefinite leave of absence on 5 June 2016.[25]

The shareholders meeting was finally held on 26 August 2016 and turned into a showdown between management and the activist fund. Interestingly, the two leading proxy advisors were split in their support for either camp.[26] Active Ownership Capital received support from Deutsche Bank's DWS fund family and other shareholders.[27] After heated debates, not all of the activist's candidates for the supervisory board were elected, but it succeeded in replacing Martin Abend, the long-time chairman, along with all but one shareholder representative on the supervisory board. Importantly, the shareholders meeting also voted to remove the restriction on share transferability from the articles.[28] Half a

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[20] A shareholding disclosure by BNY Mellon Service Kapitalanlage-Gesellschaft dated 25 February 2016, accessible at <https://www.unternehmensregister.de> (last visited 19 March 2019) likely served the stake-building effort of Active Ownership Capital as indicated by the congruence of the derivative positions.

[21] See HENNING, *supra* note 15, 3 May 2016 (reporting that large hedge funds in London and New York had shown skepticism about the potential for a sale of the firm). But see Börsen-Zeitung, BaFin nimmt sich Stada-Investor vor, 29 July 2016 (referring to an investigation by the market supervisor BaFin into a possible failure to disclose shareholdings based on coordination with other investors).

[22] See references in note 15. But see IWERSEN/TEIGHEDER, *supra* note 19) (citing Active Ownership Capital's criticism of the supervisory board's failure "to embrace reform"); HENNING, *supra* note 15, 25 May 2016 (citing a claim by the fund's managers that they were interested in improving performance). See also S. WADEWITZ, Stada-Aktionäre machen ihrem Ärger Luft, Börsen-Zeitung, 27 August 2016, 7 (reporting divergent characterizations of the fund's goals).

[23] HENNING, *supra* note 15, 25 May 2016.

[24] HENNING, *supra* note 15, 25 May 2016.

[25] IWERSEN/TEIGHEDER, *supra* note 19).

[26] S. WADEWITZ, Rückendeckung für Stada Aufsichtsrat, Börsen-Zeitung, 13 August 2016, 1; S. WADEWITZ, Stada schafft klare Verhältnisse, Börsen-Zeitung, 16 August 2016, 9.

[27] On DWS' early support, see HENNING, *supra* note 15, 25 May 2016.

[28] S. WADEWITZ, Stada droht juristisches Nachspiel, Börsen-Zeitung, 30 August 2016, 7.

year after the shareholders meeting, the executive board of Stada disclosed that it was considering overtures from three competing private equity firms.[29] After what it described as a "structured bidding process", the board on 10 April 2017 announced its support of a takeover bid by the private equity investors Bain Capital and Cinven, which had increased their offer from 58 to about 65 Euros at the last minute.[30]

But it went even better for the shareholders of Stada: In their first attempt, Bain and Cinven failed to reach their acceptance threshold of 67.5%.[31] A second, slightly improved bid with a lower acceptance threshold of 63% finally succeeded on 17 August 2017.[32] Yet in the meantime, another activist arrived on the scene: Paul Singer and his Elliott fund group notified a first stake of 8.7% in early July 2017 and by the end of August expanded it to 15.2%.[33] The new advance belongs to another activist strategy with a peculiar German flavor: interventions in ongoing acquisitions with the goal of squeezing a more attractive price from the acquirer. Elliott, in fact, has pioneered this approach that relies on at least three levers offered by the German institutional environment:[34] accumulating a share block in the takeover phase to prevent the acceptance threshold from being met, preventing in the same manner the acquirer's ability to conclude a domination agreement after the takeover, or – failing this – challenging the compensation offered in the domination agreement. In acquisitions of German stock corporations, domination agreements – a special institution under the German *Konzernrecht* (group law) –

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[29] Inside information disclosures by Stada of 12, 13, 16, and 23 February 2017, accessible at <https://www.unternehmensregister.de> (last visited 19 March 2019) (naming only Advent International and Cinven).

[30] Inside information disclosure by Stada of 10 April 2017, accessible at <https://www.unternehmensregister.de> (last visited 19 March 2019). L. BURGER / A. HÜBNER, Bain, Cinven pay up to win backing for Stada deal, Reuters, 10 April 2017, available at <https://uk.reuters.com/article/uk-stada-m-a-idUKKBN17C0CT> (last visited 19 March 2019).

[31] Inside information disclosure by Stada of 26 June 2017, accessible at <https://www.unternehmensregister.de> (last visited 19 March 2019) (noting that the threshold had already been lowered from 75%).

[32] S. CLAUSEN, Bain und Cinven gelingt Kauf von Stada – Aktie steigt stark, Manager-Magazin, 18 August 2017, available at <http://www.manager-magazin.de/unternehmen/artikel/stada-bain-capital-und-cinven-gelingt-kauf-a-1163470.html> (last visited 19 March 2019). See also inside information disclosure by Stada of 10 July 2017, accessible at <https://www.unternehmensregister.de> (last visited 19 March 2019) (disclosing Stada's consent to exemption from one-year exclusion period for renewed public takeover bid).

[33] Major shareholding disclosures by Stada of 12 July 2017 and 31 August 2017, accessible at https://www.unternehmensregister.de (last visited 19 March 2019).

[34] See the opinion piece by two Elliott managers S. WAXLEY / F. TUIL, Rechte für alle – Kampf um Wella als Blick in die Zukunft, Börsen-Zeitung, 2 April 2005, B12 (characterizing Elliott's intervention in Procter & Gamble's acquisition of Wella AG as a model); B. GRASSL / T. NIKOLEYCZIK, Shareholder Activism und Investor Activism, Die Aktiengesellschaft 2017, 49, 51 (describing a more recent intervention by Elliott).

are the necessary condition for an acquirer to avail itself of the target's assets to pay for the acquisition price.[35] Concluding a domination agreement requires a 75% qualified majority in the shareholders meeting, giving activists a realistic prospect of snatching up a veto position. As many transactions rely on the target's assets for funding, blocking the domination agreement gives activists a strong bargaining position at a point in time when the acquirer can no longer back out of the transaction. Even if the agreement goes through without additional concessions, the activist can still challenge the terms of the pay-out offer in appraisal proceedings. In the case of Stada, Elliott seems to have reached an understanding with Bain and Cinven: The profit transfer and domination agreement was approved by a 99% majority of the shareholders on 2 February 2018. It contained a pay-out offer at 74.40 Euros, a sizable premium on the takeover price, which nonetheless virtually no outside shareholder accepted.[36] The last step consisted of another offer by Bain and Cinven in October 2018, as a precondition for delisting the stock, to purchase all outstanding shares at 81.73 Euros, bringing their shareholding eventually to 93.6%.[37] This offer was finally too sweet to reject for Elliott.[38] Active Ownership Capital had sold out already in June 2017 at a stock price of around 65 Euros. Compared to the stock price of 30–35 Euros upon acquiring its stake, it had doubled its investment within a year.

The stock price chart on the following page *(Figure 1)* presents the timeline of events.

[35] For an overview of the German law of corporate groups, see K. LANGENBUCHER, Do We Need a Law of Corporate Groups?, in: Fleischer/Kanda/Kim/Mülbert (eds.), German and Asian Perspectives on Company Law (Tübingen 2016) 353, 359 ff.; A. SCHEUCH, Konzernrecht: An Overview of the German Regulation of Corporate Groups and Resulting Liability Issues, European Company Law 13 (2016) 191; T. TRÖGER, Corporate Groups, in Fleischer/Hansen/Ringe (eds.), German and Nordic Perspectives on Company Law and Capital Markets Law (Tübingen 2015) 157, 162 ff.

[36] Major shareholding disclosure by Stada of 22 October 2018, accessible at <https://www.unternehmensregister.de> (last visited 19 March 2019) (showing Cinven and Bain shareholding of 65.3% and an additional derivative position of 7% in October 2018).

[37] Stada, Annual Report 2018, 12.

[38] Major shareholding disclosure by Stada of 4 December 2018, accessible at <https://www.unternehmensregister.de> (last visited 19 March 2019) (reporting complete disposal of Elliott's stake).

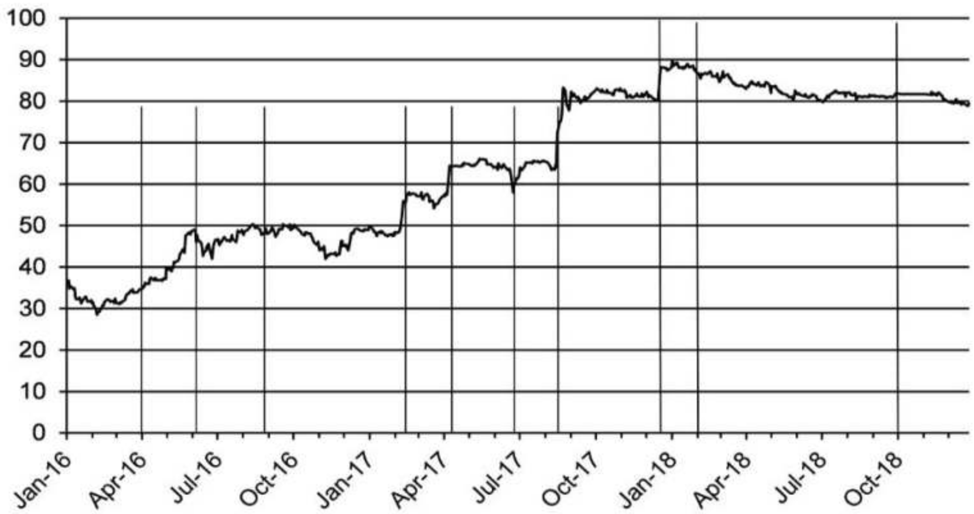

Figure 1: Stock price of Stada AG[39] and timeline of events. From left to right: disclosure of acquisition of 5% stake by Active Ownership Capital (1 April 2016); chairman of executive board Hartmut Retzlaff takes indefinite leave of absence (5 June 2016); chairman of supervisory board Martin Abend dismissed in shareholders meeting (26 August 2016); competing indications of interest from three competing bidders acknowledged (12–23 February); offer of 65 Euro from Bain and Cinven approved by executive board (10 April 2017); first takeover bid fails (16 June 2017); second bid succeeds (17 August 2017); conclusion of domination agreement (19 December 2017); approval of domination agreement by shareholders meeting (2 February 2018); announcement of acquisition offer in preparation of delisting (1 October 2018).

2. *The Larger Picture*

The Stada case encapsulates the main features of shareholder activism: Instead of broadly investing in a diversified portfolio and perhaps attempting to overweight undervalued securities, activists take concentrated positions in the stock of firms that they believe have a large potential for appreciation.[40] They then cajole and often pressure management and their fellow shareholders to

[39] The data was downloaded from the Stada website.

[40] Put differently, the business model of an activist investor is to reap returns from the asset manager's superior investment skills ("alpha", "arbitrage profits") rather than from taking market risk and earning a risk premium ("beta"). This explains why hedge funds are the epitomic activist investors, see BEBCHUK/COHEN/HIRST, *supra* note 2, 104–106; J.P.Morgan, The activist revolution, 2015, <https://www.jpmorgan.com/directdoc/JPMorgan_Corporate FinanceAdvisory_MA_TheActivistRevolution.pdf> 3–4. On the nature of hedge funds, see A. ENGERT, Transnational Hedge Fund Regulation, European Business Organization Law Review 11 (2010) 329, 333–335.

bring about the changes they deem necessary to realize the potential. When their views align with those of more traditional investors, they have a fair chance of enlisting their support and of giving their cause greater voting power than they themselves possess; the Stada management's partial defeat in the shareholders meeting of 26 August 2016 came at the hands of conventional institutions like Deutsche's asset manager DWS. If the measures are adopted, the stock price is likely to rise either because the activists' views mirror market beliefs or because the change consists of a control transaction that boosts the stock price, such as a takeover as in the case of Stada. The last step in the activist playbook is to sell at the new, elevated price. The event-driven activism practiced by Elliott can be seen as a variation of the more general theme of buying low, effecting change, and selling high.

The standard game plan of activism and its increasing use in the U.S. and around the world – including Germany – have been amply documented.[41] Empirical studies tend to confirm that activists take only minority positions[42] and hold them for one to two years on average.[43] With their campaigns, activists seek and often achieve changes in board composition, the divestiture of business units, or a takeover of the company.[44] They target predominantly smaller firms with apparently undervalued but relatively liquid stock, facilitating the build-up and eventual sale of stakes by activists.[45] Target firms also tend to have a higher level of institutional ownership before the campaign;[46] the latter

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[41] See C. THAMM/D. SCHIERECK, Shareholder Activism in Deutschland, Corporate Finance 2014, 17, 18–19 (providing an overview of existing studies on activism in Germany); 21–27 (reporting incidence, characteristics, and outcomes for 253 activist events in Germany 1999–2011); BECHT/FRANKS/GRANT/WAGNER, *supra* note 1, 2938–2943 (documenting the incidence, characteristics, and international distribution of activism 2000–2010); A. BRAV/W. JIANG/H. KIM, Recent Advances in Research on Hedge Fund Activism, Annual Review of Financial Economics 7 (2015) 579, 580–583 (summarizing the incidence and characteristics of activism in the U.S., 1994–2011). See also the broader survey on the full range of shareholder activities in corporate governance by DENES/KARPOFF/MCWILLIAMS, *supra* note 8).

[42] See, e.g., BECHT/FRANKS/GRANT/WAGNER, *supra* note 1, 2939.

[43] See BRAV/JIANG/KIM, *supra* note 41, 583.

[44] See THAMM/SCHIERECK, *supra* note 41, 17, 27 (Germany); STADLER/ZU KNYPHAUSEN-AUFSESS, Shareholder activism by hedge funds in a concentrated ownership environment: an empirical study for Germany, International Journal of Financial Services Management 8 (2015, 58, 67–68 (Germany); BECHT/FRANKS/GRANT/WAGNER, *supra* note 1, 2952–2953 (international sample); BRAV/JIANG/KIM, *supra* note 41, 582 (USA).

[45] See BECHT/FRANKS/GRANT/WAGNER, *supra* note 1, 2939; BRAV/JIANG/KIM, *supra* note 41, 583–584; but see W. BESSLER/W. DROBETZ/J. HOLLER, The Returns to Hedge Fund Activism in Germany, European Financial Management 21 (2015) 106, 120–122 (finding that German targets exhibit significantly lower returns to assets but seem not to differ in their market-to-book ratio).

[46] See BECHT/FRANKS/GRANT/WAGNER, *supra* note 1, 2939; BRAV/JIANG/KIM, *supra* note 41, 583–584.

observation could reflect the support that institutional investors lend to activists.[47] Lastly, one would believe activists to shun companies with controlling shareholders as it is difficult or impossible to win a vote against such insiders.[48] In fact, Stada was widely owned when it became the target of Active Ownership Capital.[49] The ownership structure of German listed corporations is generally less conducive to shareholder activism; *Figure 2* shows that 40% of public companies have a majority shareholder and more than 55% have at least a 30% blockholder. Nonetheless, a considerable number of activist interventions have been recorded in Germany. A recent study for the relatively early period of 2000–2006 counts no less than 217 engagements but with a focus on companies with a comparatively less concentrated ownership.[50]

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[47] Specifically on the reinforcing role of passive index funds, see I. APPEL/T. GORMLEY/D. KEIM, Standing on the Shoulders of Giants: The Effect of Passive Investors on Activists, The Review of Financial Studies 32 (2019) 2721; for the importance of proxy advisers in Germany and other European countries, see J.-M. HITZ/N. LEHMANN, Empirical Evidence on the Role of Proxy Advisors in European Capital Markets, European Accounting Review 27 (2018) 713, 720 (documenting that 46.8% of German listed firms were covered by the largest proxy advisor ISS in 2008–2010).

[48] But see K. KASTIEL, Against All Odds: Hedge Fund Activism in Controlled Companies, Columbia Business Law Review 60 (2016) 60 (analyzing activist engagements in corporations with controlling shareholders).

[49] As of 1 April 2016, the only major holdings in the BaFin database were DWS (5.04%), BNY Mellon Service Kapitalanlage-Gesellschaft (3.21%), and LSV Asset Management (3.07%).

[50] BESSLER/DROBETZ/HOLLER, *supra* note 45, 115, 124 (reporting a lower median maximum shareholding than the greater than 30% value depicted in *Figure 2*). But see M. MIETZNER/D. SCHWEIZER, Hedge funds versus private equity funds as shareholder activists in Germany – differences in value creation, Journal of Economics and Finance 38 (2014) 181, 186 (finding only 67 instances for 2001–2007 with a much more restrictive data-gathering procedure); similarly T. H. DRERUP, Long-Term Effects of Hedge Fund Activism in Germany, 2014, available at SSRN: <https://ssrn.com/abstract=1718365> (last visited 12 July 2019) 9–11 (142 activist blockholdings and 136 passive investments by hedge funds 1999–2010).

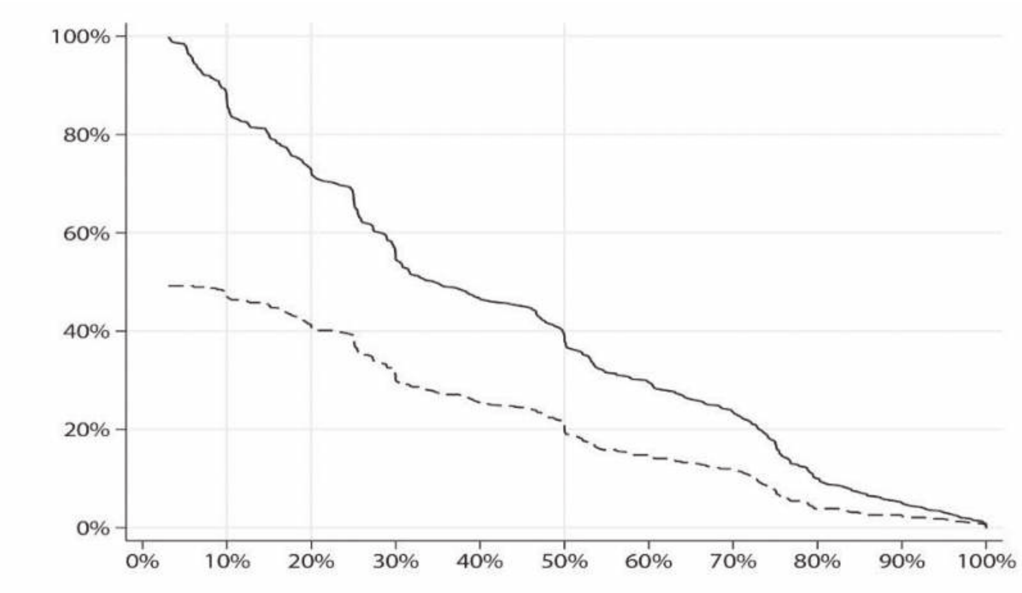

Figure 2: Reverse cumulative distribution of the largest shareholding in a sample of 384 listed German stock corporations as of December 2017.[51] The solid line shows the percentage of companies (vertical axis) with a largest shareholder directly or indirectly holding at least as many voting rights as shown on the horizontal axis. The dashed line represents the corresponding percentage of natural persons as largest shareholders.

The most interesting question from a policy perspective concerns the evaluation of shareholder activism. A simple and rather compelling argument suggests that activists perform a valuable service to other shareholders: To produce a positive risk-adjusted return from their investments, activists must be able, on average, to "buy low and sell high." For this, the market valuation of the firm needs to increase from the activists' taking a position to exiting it. Unless activists systematically lose money or the market systematically mistakes actual value losses for gains, it follows that activist interventions on average benefit stock value and shareholders. The empirical evidence tends to support this view. As *Figure 3* documents for Germany, the stock market reacts favorably when it learns that a company has become the target of one or more activists.[52] Stock appreciation widens when activists obtain concessions or otherwise accomplish their goals.[53] Also, activists appear to be far more effective than conventional institutional shareholders at implementing value-enhancing chang-

[51] The figure is adopted from A. ENGERT/T. FLORSTEDT, Which Related Party Transactions Should Be Subject to Ex Ante Review?, ECGI Law Working Paper 440, 2019.

[52] See the overview by BRAV/JIANG/KIM, *supra* note 41, 584–586. For Germany, see MIETZNER/SCHWEIZER, *supra* note 50, 192–195; BESSLER/DROBETZ/HOLLER, *supra* note 45, 124–130. For an international sample, see BECHT/FRANKS/GRANT/WAGNER, *supra* note 1, 2948–2950.

[53] BECHT/FRANKS/GRANT/WAGNER, *supra* note 1).

es.[54] The evidence is more mixed when it comes to the effects of activism on real operating performance, on long-run stock returns, and on other stakeholders.[55] It could well be the case that much or even all of the gains to shareholders result from a costly redistribution of firm value at the expense of creditors and employees. This possibility entails a task description for the law in regulating shareholder activism. The legal framework should seek to encourage activism when it is valuable and minimize the destructive occurrences. Unfortunately, the law seems not well equipped to accomplish this. Most of the rules in place, at least in Germany, seem to either facilitate or restrain activism but without much regard for the consequences in the particular case.

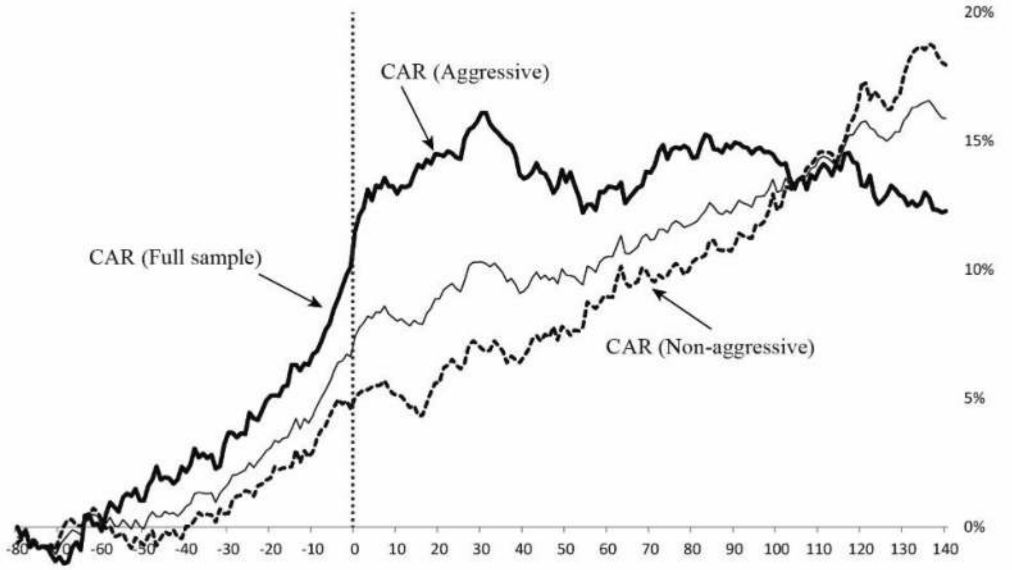

Figure 3: Cumulative abnormal returns of German stock starting 80 days before until 140 days after the release of information about an activist engagement with the respective company. The thin line represents the full sample of 231 activist events studied by Bessler/Drobetz/Holler.[56] The bold and dotted lines show the returns of subsamples of events involving activists with more (bold) or less (dotted) aggressive tactics.

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[54] See the overview of empirical results on valuation effects of different types of shareholder activities in DENES/KARPOFF/MCWILLIAMS, *supra* note 8, 417.

[55] See A. BRAV/W. JIANG/H. KIM, The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes, The Review of Financial Studies 28 (2015) 2723 (arguing that activism enhances labor and capital productivity); L. BEBCHUK/A. BRAV/W. JIANG, The Long-Term Effects of Hedge Fund Activism, Columbia Law Review 115 (2015) 1085, 1123–1130 (finding no significant reversal of initial price increases over subsequent three years); E. DEHAAN/D. LARCKER/C. MCCLURE, Long-Term Economic Consequences of Hedge Fund Activist Interventions, ECGI Finance Working Paper 577, 2018 (finding no significant long-term price effects of activism and no improvements in operating performance). As to the effects on other stakeholders, see BRAV/JIANG/KIM, *supra* note 41, 589–590.

[56] BESSLER/DROBETZ/HOLLER, *supra* note 45, 127.

III. Activist Stake Building under German Law

Activists use shares in the target corporation in two respects: They leverage the rights of shareholders to pressure management, and they seek to benefit from a resulting increase in the share price. Acquiring a substantial shareholding in the corporation's stock before and during a campaign therefore is an essential piece of their game plan. In the course of building a stake, a critical legal issue for activists is the requirement to disclose their identities and shareholdings upon crossing specific thresholds (Subsection 1). In addition, one may wonder whether activists could run afoul of insider trading rules (Subsection 2).[57]

1. Major Holdings and Related Disclosures

The contribution by *Bachmann* in this volume covers the disclosure requirements for major holdings of listed corporations under German law and also discusses their rationale.[58] To avoid duplication, the following focuses on aspects of particular relevance for activists. Especially in the early stages of their campaign, having to disclose their identity and the size of their shareholding clearly is not in their interest. Since activists build a reputation on their repeated success, their arrival signals to other investors that a change in the corporate strategy or governance is becoming more likely and that it could ultimately boost firm value. Anticipating this outcome, the stock price increases and impedes the further expansion of the activist stake needed to influence management and to profit from it.[59] Activists, therefore, will be very mindful especially of the lowest voting rights threshold – which the German legislature in 2007 lowered from 5% to 3%, arguably in response to the successful activist campaign against the management of Deutsche Börse in 2005.[60] Further thresholds are at 5%, 10%, 15%, 20%, 25%, 30%, 50%, and 75%.[61] Crossing any of these

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[57] Recently, the power to prohibit acquisitions of German firms by foreign investors under §§ 55–62 Foreign Trade and Payments Ordinance (Außenwirtschaftsverordnung, AWV) has received heightened attention, especially in relation to investors from China. Because the regime applies almost exclusively to non-EU investors and is triggered at a rather high 25% shareholding (see § 56 of the Ordinance) it has little effect on activists.

[58] See §§ 33–47 STA (Securities Trading Act, Wertpapierhandelsgesetz, WpHG). Note that the STA has been renumbered as of 2018; before then, the provisions were contained in §§ 21–30 STA. An English translation of the STA, unfortunately only as of June 2011, is available at <https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Gesetz/WpHG_en.html> (last visited 27 October 2018).

[59] The standard economics reference work for this problem in the takeover context is S. J. GROSSMAN/O. HART, Takeover bids, the free-rider problem and the theory of the corporation, The Bell Journal of Economics 11 (1980) 42, 42–47.

[60] The draft mentions "experiences in the very recent past", Bundesrat, printed paper 579/06, p. 74.

[61] § 33 para. 1 STA (formerly § 22 para. 1 STA).

limits, either by increasing or reducing one's shareholding, triggers a duty to report one's identity and the resulting voting rights share (but without a duty to update the share subsequently, absent a new threshold contact). The report has to be publicized without undue delay, at most within seven trading days of crossing the threshold;[62] this affords activists additional time to accumulate more shares at the lower pre-announcement price.

Importantly, attribution rules seek to capture indirect economic ownership of voting rights, such as through subsidiaries or fiduciaries. A particularly complex and consequential rule for activists is that voting rights are imputed to each of two or several (direct or indirect) shareholders who "coordinate [… their …] conduct in respect of the issuer".[63] If multiple activists simultaneously approach a target, they will be wary not to be "acting in concert" under this provision to avoid having to aggregate their holdings, which would lead to their hitting the disclosure threshold much earlier.[64] It is the German version of the art of walking a fine line between a "wolf pack" (no aggregation) and a "group" (triggering aggregation).[65] What constitutes acting in concert has raised a number of thorny issues, especially regarding the nature and intensity of the influence on which members of the group have to coordinate.[66]

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[62] See §§ 33 para. 1, 40 para. 1 STA. Trading days exclude weekends and certain public holidays, see § 47 para. 1 STA.

[63] § 33 para. 2 STA (formerly §22 para. 2 STA).

[64] In addition, mutual attribution based on "acting in concert" is virtually the only way in which activists ever risk triggering the duty to extend a takeover offer for all target shares under §§ 35 para. 1, 29 para. 2, 30 Takeover Act (Wertpapiererwerbs- und Übernahmegesetz, WpÜG). An English translation of the Takeover Act, unfortunately only as of December 2011, is available at <https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Gesetz/WpUEG_en.html> (last visited 27 October 2018).

[65] For the U.S., see J. C. Coffee/D. Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, Annals of Corporate Governance 1 (2016) 1, 24–36 (defining "wolf packs" and explaining the workings of the tactic under U.S. law). For important differences in insider trading regulation between the U.S. and Germany, see Langenbucher, *supra* note 7, 749–750. See also Becht/Franks/Grant/Wagner, *supra* note 1, 2940–2943 (tallying the frequency of observable engagements by more than one hedge fund at 21.7%); Bessler/Drobetz/Holler, *supra* note 45, 116–117 (around 23% of visible wolf packs in a German sample).

[66] For excellent overviews of the legal analysis in Germany in English, see D. A. Verse, Acting in Concert in German Company and Takeover Law, in: Fleischer/Hansen/Ringe (eds.), German and Nordic Perspectives on Company Law and Capital Markets Law (Tübingen 2015) 215; A. Taleska, Shareholder Proponents as Control Acquirers: A British, German and Italian Perspective on the Regulation of Collective Shareholder Activism via Takeover Rules, European Business Organization Law Review 19 (2018) 797, 819–822; see also the recent judgment BGH, 25 September 2018, II ZR 190/17, Neue Juristische Wochenschrift 2019, 219 (excluding voting agreements in "single instances" even if the vote has far-reaching strategic implications and rejecting the opposite view of BaFin, the market supervisor).

Also in response to the Deutsche Börse incident, the German legislature introduced the duty of a shareholder crossing the 10% threshold (or a higher threshold) to provide information on his intentions and the financing of the acquisition within 20 trading days.[67] The investor is required to disclose, among other things, whether he intends to acquire additional voting rights, to influence the election of corporate directors, or to change the corporation's capital structure. As regards the financing of the transaction, the shareholder only needs to state the debt ratio.[68] In contrast to holdings disclosures, a failure to provide the additional information about intentions and funding carries no specific sanction.[69]

A last element of the disclosure regime for major shareholders concerns derivative positions. After a meandering development, the current rules comprehensively cover the use of derivatives to create economic ownership – a "long" position – in vote-bearing stock of a listed corporation. The most significant recent change was the inclusion of cash-settled derivatives.[70] The compelling reason behind counting even purely financial long positions is that they hedge their holder against a rise in the stock price; because she can always acquire shares in the open market, this is the equivalent of a call option with physical delivery. Disclosure duties for derivatives attach separately to the voting rights embodied in derivatives and to the sum of voting rights from shares and derivatives; only the lowest 3% threshold is excluded.[71] For the purpose of calculating long positions, short positions are not subtracted.[72] Still, the market as well as the corporation's management can be interested in whether an activist holds a countervailing short position in the stock of the target corporation.[73] Yet a disclosure duty arises only for net short positions,

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[67] § 43 para. 1 STA (formerly § 27a STA).

[68] See the legislative reasoning, Bundestag, printed paper 16/7438, p. 12.

[69] Other than the issuer having to publicize non-compliance, § 43 para. 2 STA. For a potential liability for market manipulation, see U. H. SCHNEIDER, in: Assmann/Schneider/Mülbert, Wertpapierhandelsrecht (7th ed., Cologne 2019) § 43 WpHG, para. 30. For the rather severe implications of not disclosing major holdings see BACHMANN in this volume, p. 89.

[70] See § 38 para. 1 lit. b STA (formerly § 25 STA) and again BACHMANN in this volume, p. 89.

[71] See §§ 38 para. 1, 39 para. 1 STA.

[72] See § 38 para. 4 sent. 2 STA.

[73] In the mid-2000s, there was a concern about potential conflicts of interest caused by "empty voting," that is a voting rights share with an incongruous economic interest in the firm, see A. BRAV/M. D. RICHMOND, Empty voting and the efficiency of corporate governance, Journal of Financial Economics 99 (2011) 289, 289–90 (summarizing the policy debate); from a German perspective ENGERT, *supra* note 4, 2107–2108; C. OSTERLOH-KONRAD, Gefährdet "Empty Voting" die Willensbildung in der Aktiengesellschaft?, Zeitschrift für Unternehmens- und Gesellschaftsrecht 2012, 35.

that is, only in the extreme case that the activist would stand to benefit overall from a decline in the stock price.[74]

2. Activists' Intentions as Inside Information

In addition to disclosure duties regarding shareholdings and intentions, insider trading regulation could pose another problem. National laws on insider trading have been harmonized in the EU since the 1990s. They are now governed by the EU's Market Abuse Regulation[75] (MAR) that in 2016 supplanted Member State rules. Unsurprisingly, activists must not "use" inside information in their decision to acquire stock in the corporation.[76] This effectively precludes them from building or extending a stake if they have, for instance, obtained relevant non-public information from directors of the corporation.[77] The more interesting question is whether the activists' own intentions constitute inside information and are "used" when activists trade to carry out their plans. The BGH at some point ruled out this possibility by excluding a person's own mental states from the notion of "information."[78] This view is less than compelling.[79] It would imply that, for instance, the individual manager of an activist hedge fund could exploit, for her own private account, her intention to acquire a substantial shareholding in a new target on behalf of the fund. Contrary to the court's contention, the literal meaning of "information" quite naturally encompasses a mental state such as a self-devised strategy or plan.[80] An activist's decision to build a major stake in a corporation also often satisfies the further elements of

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[74] See Art. 6 paras. 1, 2 Short Selling Regulation (EU) No. 236/2012 (imposing a disclosure duty for net short positions in excess of .5% of an issuer's share capital). See also Art. 3 para. 1 and recital 5 Delegated Regulation (EU) No 918/2012 (defining ownership in terms of the "ultimate beneficial owner" to prevent avoidance of the disclosure duty).

[75] Market Abuse Regulation (EU) No. 596/2014.

[76] Art. 14 lit. a, 8 para. 1 MAR.

[77] Recitals 24, 25 MAR create a presumption that possession of inside information implies its use in the transaction. The recitals follow ECJ, 23 December 2009, C-45/08, *Spector Photo Group,* ECLI:EU:C:2009:806, paras. 38, 45–62.

[78] BGH, 6 November 2003, 1 StR 24/03, *Sascha Opel,* BGHSt 48, 373, 378–79 (arguing that the literal meaning of "information" presupposes an external reference because one can hardly become "informed" of one's own thoughts).

[79] H.-D. ASSMANN, in: Assmann/Schneider/Mülbert (eds.), *supra* note 69, Art. 7 MAR para. 17; L. KLÖHN, "Selbst geschaffene innere Tatsachen", Scalping und Stakebuilding im neuen Marktmissbrauchsrecht, supplement to Zeitschrift für Wirtschaftsrecht issue 22, 2016, 44 (each also citing the substantial following of the judgment).

[80] Recital 31 sent. 2 and Art. 9 para. 5 MAR may be read as treating an intention as information (but dismissing that its execution constitutes "use" of that information). The ECJ has so far only stated that a common decision of several individuals – which goes beyond a mental state – constitutes "information," see ECJ, 10 May 2007, C-391/04, *Georgakis,* ECLI:EU:C:2007:272, paras. 32–34. See also KLÖHN, *supra* note 79, 46 (dismissing recital 54 sent. 3 MAR).

inside information: it will usually be non-public, sufficiently precise, and capable of significantly affecting the stock price if publicized.[81] Nonetheless, Art. 9 para. 5 MAR makes it plain that carrying out one's intention to trade does not come under the insider trading prohibition. The proper reason is that the decision to trade, though "information," is not being "used" in the transaction in the sense implied by the insider trading prohibition. In *Spector Photo Group,* the ECJ has established the principle that inside information is only "used" if the informed trader takes "unfair advantage" of the information.[82] Art. 9 para. 5 MAR essentially implies that executing one's own trading decision should not be viewed as obtaining an "unfair advantage" lest any major transaction require previous public announcement.

While Art. 9 para. 5 MAR contents itself with addressing a rather simple case, a more difficult issue is whether activists' further intention of mending the management or strategy of the target corporation is information that confers an "unfair advantage."[83] In this regard, activists have privileged information not just about their own trading but about their potential effect on the corporation and its business. Exploiting this foreknowledge is critical to the activists' investment strategy of buying low, effecting change, and selling high. Whether this informational advantage is fair decides the fate of shareholder activism. The problem has received scant attention, perhaps because many find the solution obvious. There is a close analogy to the more well-known problem of stake building in the preparation of a takeover. Such acquisitions before a public bid are common practice and widely accepted, and yet they would violate insider trading laws if the undisclosed intention to seize control were judged to confer an unfair advantage.[84] A justification is that the takeover as a business opportunity is a creation of the bidder's own effort and ingenuity. It is not unfair for the bidder to claim the value of this productive discovery for himself, except to the extent shareholding disclosure rules force him to reveal information.[85] This same line of reasoning extends

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[81] Art. 7 para. 1 lit. a MAR contains the definition of inside information. On the requirement that information be precise, see *infra* IV.2.a).

[82] ECJ, 23 December 2009, C-45/08, *Spector Photo Group,* ECLI:EU:C:2009:806, paras. 52–53, 61–62. The principle has been endorsed in recitals 23, 24 sent. 3 MAR.

[83] Cf. H. SCHÄFER, Shareholder Activism und Corporate Governance, Neue Zeitschrift für Gesellschaftsrecht 2007, 900, 901 (discussions with target management as inside information).

[84] Art. 9 para. 4 MAR could be (mis)read to this effect: If the plan to pursue a takeover were regarded as "inside information [obtained] in the conduct of a public takeover", the provision would legitimize its use in the public takeover but not in a prior stake building, see the second subparagraph and Art. 3(31) MAR.

[85] ENGERT, *supra* note 4, 2109. See also H.-D. ASSMANN, in: Assmann/Schneider/Mülbert (eds.), *supra* note 69, Art. 8 MAR paras. 47, 59 (contending that the implementation of business decisions as such does not constitute use of inside information).

to shareholder activists and their strategy of increasing the market value of a corporation by pressuring its leadership.[86] The argument also suggests that an activist can selectively share his investment idea to attract likeminded other investors – form a "wolf pack" – without committing illegal "tipping."[87]

IV. Interaction between Activists and Managers under German Law

Having acquired a sizable stake, activists will invariably approach the firm's management to advance their agenda. The arrival of assertive new investors is unlikely to please the directors on the two boards of a German stock corporation, the *Aufsichtsrat* (supervisory board) and the *Vorstand* (executive board). But directors have good reason to enter into a conversation with the firm's new vocal minority. Their inclination to listen to activists reflects the powers of shareholders in a German stock corporation, which Subsection 1 briefly summarizes. The following two subsections consider in more depth two important aspects of management's dealings with activists: firstly, the disclosure of information as part of the dialogue with activists (Subsection 2), and secondly the ability of supervisory and executive directors to concede to their demands (Subsection 3).

1. Shareholders' Powers in the German Stock Corporation

As a general rule, the powers of the shareholders over corporate affairs are to be exercised in the *Hauptversammlung* (shareholders meeting).[88] These powers are narrowly confined. Shareholders are precluded from directly determining the firm's business strategy, which falls primarily under the domain of the executive board.[89] Shareholders can neither instruct nor elect the executive directors. Their only lever on corporate management is the right to elect and – with a 75% majority – to terminate directors on the supervisory

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[86] ENGERT, *supra* note 4, 2109–2110 (but arguing for an exception if activists predominantly take a short position with a view to harming the corporation).

[87] Such selective disclosure is made "in the normal exercise of an employment, profession or duties" under Art. 10 para. 1 MAR. But see LANGENBUCHER, *supra* note 7, 749–750 (maintaining that informing others of the crossing of a relevant threshold under holdings disclosure rules before publication could constitute illegal tipping).

[88] See, explicitly, § 118 para. 1 SCA (Stock Corporation Act, Aktiengesetz, AktG). The Federal Ministry of Justice provides an English translation of the statute as of 2017 at <http://www.gesetze-im-internet.de/englisch_aktg/index.html> (last visited 10 July 2019).

[89] On the division of labor between the executive and the supervisory board, see *infra* IV.3.a).

board.[90] The supervisory board in turn elects the executive directors for a maximum period of five years; dismissing executive directors before the end of their term requires an additional shareholder vote of no confidence.[91] Overall, management enjoys a surprising degree of insulation from shareholder pressure compared to other jurisdictions, especially at the earlier stages of a supervisory board's tenure. Nonetheless, the position of management is far from comfortable. It remains a vital concern for managers to ensure majority support in the shareholders meeting, not least because clinging to one's office against a shareholder majority likely diminishes career prospects in other public firms. An indication of this is the great importance managers attribute to winning the mandatory discharge vote in the annual shareholders meeting, in spite of it having no legal consequences.[92]

On their own, activists hardly ever command a majority of the votes in the shareholders meeting. Their power derives from offering their fellow shareholders an alternative to the strategy of management and perhaps also to the incumbent managers themselves. To garner support from institutional investors and proxy advisors,[93] activists need to create the perception that they are advocating the interests and views of shareholders. Other investors find themselves in the convenient position of an audience to which two rival camps appeal for approval. The contest forces managers to attend better to shareholder concerns. Because of this welcome disciplinary effect, other investors will be cautious not to discourage activists and will penalize management for not engaging with their demands.

In addition to enlisting the support of other shareholders, activists occasionally can invoke certain rights granted to a minority or to individual shareholders. Most of them relate to the shareholders meeting, such as the rights to request a shareholders meeting or to add items to the agenda (5% minority), to have countermotions disseminated to other shareholders (individual shareholders), to a vote on shareholder nominees prior to candidates proposed by the supervisory board (10% minority), and to demand a separate vote on the discharge of individual directors (10% minority).[94] Executive directors have to respond to questions of individual shareholders during the shareholders

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[90] Supervisory board directors are often elected for the statutory maximum term of five years, see § 102 para. 1 SCA. The articles of incorporation can – but rarely do – relax the 75% majority requirement, see § 103 para. 1 SCA.

[91] See § 84 paras. 1, 3 SCA.

[92] See § 120 paras. 1, 2 SCA.

[93] For the relevance of institutional investors for activism, see *supra* note 45, 46, and accompanying text.

[94] § 122 SCA (shareholders meeting or item requests), §§ 126, 127 SCA (dissemination of counterproposals), § 120 para. 1 SCA (discharge vote), § 137 SCA (prior vote on shareholder nominees).

meeting.[95] After the shareholders meeting, individual shareholders can challenge any resolution for violation of procedural or substantive law, including of other shareholders' fiduciary duties and the articles of incorporation.[96] To scrutinize the conduct of directors and pursue claims against them, a 1% minority can petition the court to appoint a special investigator if facts suggest dishonest behavior or gross violations of the law or the articles; the investigator provides a written report, of which any shareholder can receive a copy.[97] Furthermore, a 1% minority can petition the court to grant them standing to bring claims on behalf of the corporation against directors if, again, there is reason to believe that dishonest behavior or gross violations have occurred and if certain other conditions are met.[98]

2. *Sharing Information*

Even if shareholders may be somewhat less powerful in German stock corporations than elsewhere, there is still ample reason for managers to take an activist advance seriously. A first condition for meaningful interaction is the ability to exchange information. For instance, objections against proposals by activists often rely on inside knowledge of the particular circumstances, such as accounting intricacies or unrevealed business opportunities.[99] Management may also want to disclose its own strategies and intentions to avert an unnecessary and costly conflict with activists. Yet sharing information is subject to restrictions under securities regulation and general corporate law.

a) Insider trading regulation

Insider trading rules impose a first constraint. Among other types of behavior, the MAR proscribes not only using inside information in transactions but also the "unlawful disclosure" of it.[100] "Inside information" is defined as non-

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[95] § 131 SCA. On § 131 para. 4 SCA, see *infra* text following note 123.

[96] Anfechtungsklage (annulment action), §§ 243, 245, 246 SCA. For certain structural changes such as mergers or domination agreements, shareholders can initiate appraisal proceedings to claim compensation, see, e.g., § 305 para. 5 SCA. For the use of this right by activists, see *supra* text following note 33.

[97] §§ 142 para. 2, 145 para. 6 SCA.

[98] See § 148 para. 1 SCA. Important further restrictions are a demand requirement and that the minority must have learned of the conduct after acquiring its shareholding. The minority right under § 147 para. 2 SCA to institute a special corporate representatives for an action against directors has not gained in importance because it presupposes a prior resolution by a simple majority in the shareholders meeting to bring claims under § 147 para. 1 SCA.

[99] See, e.g., SCHIESSL, *supra* note 6, 693 (arguing that a discussion of specific proposals often involves a presentation of accounting and tax implications).

[100] Art. 14 lit. c, 10 para. 1 MAR. Recital 19 MAR expresses that "[t]his Regulation is not intended to prohibit discussions of a general nature regarding the business and market developments between shareholders and management concerning an issuer."

public, precise information relating to the corporation, its shares, other issuers, or financial instruments when it is likely to have a significant effect on prices if publicized.[101] The significant price effect hinges on whether a reasonable investor would take the information into account in her investment decisions[102] – whether she has an incentive to use the information.[103] Activists will often be interested in corporate strategy, a possible restructuring, or major transactions. Even discussing such fundamental changes leads management to share its own views and intentions. The fact that management is actively contemplating a spin-off may well move stock prices.

In spite of the potential price effect, such information could still fail to be "precise." This additional element poses considerable difficulty in determining when exactly a process of corporate decision-making creates inside information. The MAR clarifies that intermediate steps can themselves constitute "inside information."[104] In the *Geltl* case concerning the resignation of a CEO, the ECJ held that information about uncertain facts or events – such as the potential demise of the CEO – is "precise" only if the fact or event is not "implausible" but has a "realistic prospect" of existing or occurring. The Court explicitly ruled out that the probability should be linked to the magnitude of the possible effect on prices in the sense that a more consequential fact or event implied a lower probability threshold.[105] In the Court's view, the additional requirement of "precise" information serves to enhance legal certainty,[106] especially with regard to an issuer's duty to publicize promptly inside information that "directly concerns" them.[107] This rationale suggests that even a significant price effect

[101] Art. 7 para. 1 lit. a MAR.

[102] Art. 7 para. 4 MAR.

[103] If the effect is uncertain, a reasonable investor would rely on the expected price change, i.e., the sum of possible changes weighted by their probabilities. If the information affects the probability of an event (or fact) only little, the event's (or fact's) impact on value must be correspondingly larger (probability-magnitude formula). Cf. ECJ, 28 June 2012, C-19/11, *Geltl v Daimler,* ECLI:EU:C:2012:397, para. 55; BGH, 23 April 2013, II ZB 7/09, Neue Juristische Wochenschrift 2013, 2114, para. 25; L. KLÖHN, Das deutsche und europäische Insiderrecht nach dem Geltl-Urteil des EuGH, Zeitschrift für Wirtschaftsrecht 2012, 1885, 1891.

[104] Art. 7 para. 3 MAR.

[105] ECJ, 28 June 2012, C-19/11, *Geltl v Daimler,* ECLI:EU:C:2012:397, paras. 48–55. Recital 16 MAR incorporates the "realistic prospect" language (in German: "realistische Wahrscheinlichkeit" instead of "tatsächlich erwartet" as found in the ECJ's judgment) as well as the ECJ's dismissal of the magnitude of the possible price impact.

[106] ECJ, 28 June 2012, C-19/11, *Geltl v Daimler,* ECLI:EU:C:2012:397, para. 48. Practitioners likewise articulate a need for certainty, see D. KOCHER/S. WIDDER, Die Bedeutung von Zwischenschritten bei der Definition von Insiderinformationen, Betriebs-Berater 2012, 2837, 2839.

[107] Art. 17 para. 1 MAR. Issuers can defer disclosure if they have a legitimate interest in doing so and further conditions are met, Art. 17 para. 4 MAR. In this case, they are required to record when they became aware of the inside information and decided to delay disclosure,

should be disregarded if it is caused by the anticipation of a future event – the demise of the CEO – for which there is not (yet) a "realistic prospect." In fact, there could well be more agreement about when an important event has a "realistic prospect" of occurring than about when probabilities have changed sufficiently to induce a reasonable investor to trade on the information. The flip side, of course, is that insiders are allowed to exploit an informational advantage for personal gain so long as the "realistic prospect" threshold is not met.[108] Such profit opportunities exist whenever non-public information is capable of having a significant effect on prices.

To avoid this consequence, it has been argued that knowledge of the intermediate step – the CEO discussing her resignation with a confidant – constitutes information in its own right and as such is clearly "precise."[109] To qualify as inside information, it only remains to show that it affects the stock price when published. This view renders the ECJ's jurisprudence in *Geltl* obsolete because early indications of important events are typically themselves "precise" information (such as the fact that a discussion of the matter took place).[110] If the ECJ intends to promote predictability for issuers, it will need to abstract from price effects of intermediate events due to potential later events that do not yet meet the realistic prospect test.[111]

Taking the ECJ's ruling in Geltl seriously, management only conveys inside information if its statements create a "realistic prospect" of a later transaction or other price-relevant event of which the investing public is unaware. German commentators tend to equate the "realistic prospect" with a more-likely-than-not standard.[112] Instead of a purely probabilistic threshold,[113] it

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along with other information, Art. 4 para. 1 Implementing Regulation (EU) 2016/1055. After publication, the information has to be passed to the market supervisor, Art. 17 para. 4 subpara. 3 MAR.

[108] This point is rightly and forcefully made by L. KLÖHN, in: Klöhn, Marktmissbrauchsverordnung (Munich 2018) Art. 7, para. 109.

[109] See KLÖHN, *supra* note 108, Art. 7, paras. 100–103.

[110] See KLÖHN, *supra* note 108, Art. 7, paras. 110–111 (admitting that the realistic prospect test retains little importance other than precluding a duty to disclose the potential future event rather than just the past indicator event); H. KRAUSE/M. BRELLOCHS, Insider trading and the disclosure of inside information after Geltl v Daimler – A comparative analysis of the ECJ decision in the Geltl v Daimler case with a view to the future European Market Abuse Regulation, Capital Markets Law Journal 8 (2013) 283, 290.

[111] See G. BACHMANN, Ad-hoc-Publizität nach "Geltl", Der Betrieb 2012, 2206, 2209–10; D. KOCHER/S. WIDDER, Die Bedeutung von Zwischenschritten bei der Definition von Insiderinformationen, Betriebs-Berater 2012, 2837, 2840–41. This operation has been called a "blocking effect" of the realistic-prospect test in relation to the preceding event's price effect, KLÖHN, *supra* note 108, Art. 7, paras. 104–110.

[112] KRAUSE/BRELLOCHS, *supra* note 110, 288–289; A. SCHALL, Anmerkung zum Urteil des EuGH vom 28.6.2012, Rs. C-19/11 – Insiderinformationen und Publizitätspflichten in gestreckten Entscheidungsprozessen, Zeitschrift für Wirtschaftsrecht 2012, 1286, 1288;

seems more attuned to the decision-making context to demand that a potential transaction or measure has been sufficiently elaborated to receive extensive consideration from decision-makers and, in this sense, has become a serious option. Even thorough discussions with activists – who remain outside management – hardly suffice to produce such inside information.

When, perhaps as a result of activists' pressure, a major transaction or strategy change has become a realistic possibility, this triggers the general duty to publicize such inside information.[114] Management can delay disclosure in order to safeguard a legitimate interest of the issuer, provided the public is not misled and confidentiality is kept. Ensuring an orderly decision-making process and avoiding a commitment effect from premature disclosure can justify a delay.[115] It is conceivable that management, while delaying publication, might nevertheless want to assuage activists by privately revealing and discussing its emerging plans. Yet non-public disclosure of inside information is prohibited except if made "in the normal exercise of an employment, a profession or duties."[116] The ECJ has emphasized that conveying the information must be "strictly necessary" for the exercise of management's responsibilities.[117] This is an exacting standard. Nonetheless, one can imagine a situation where activists threaten to wage an all-out battle to press for changes that management is already about to devise and implement, thereby detracting much time and attention from the actual task. Under circumstances like these, it could be "strictly necessary" for the interest of the company to appease activists by confidentially disclosing management's intentions. As the strictly-necessary test demands that the information leakage be kept to a minimum,[118] management must make it explicit that inside information is being shared, thereby subjecting the activists to the insider trading restrictions with regard to the information.[119]

D. POELZIG, Insider-und Marktmanipulationsverbot im neuen Marktmissbrauchsrecht, Neue Zeitschrift für Gesellschaftsrecht 2016, 528, 532.

[113] The German and Spanish versions of recital 16 sent. 2 MAR refer to a "reasonable" or "realistic" probability, while the English, French, and Dutch versions speak of a realistic "prospect," "perspective," or "assumption," respectively.

[114] See note 107 above.

[115] See Art. 17 para. 4 subpara. 2 MAR (multi-stage decision process as potential reason for legitimate delay); recital 50 lit. b MAR and ESMA, MAR Guidelines, Delay in the disclosure of inside information, ESMA/2016/1478, para. 8 lits. a, c (ongoing negotiations and pending approval by another corporate body as examples of legitimate interests).

[116] Art. 10 para. 1 MAR.

[117] ECJ, 22 November 2005, C-384/02, *Grøngaard and Bang,* ECLI:EU:C:2005:708, paras. 34–38, 48.

[118] This is also a precondition for a continued delay of public disclosure, see Art. 17 para. 4 lit. c MAR.

[119] While not directly applicable, the market sounding provisions in Art. 11 para. 5 MAR give a good indication of what is required. In the absence of a proper confidentiality

b) *Corporate law duties of confidentiality and equal treatment*

Besides securities regulation, information disclosure also raises issues under corporate law. Fiduciary duties prevent the directors of a German stock corporation from sharing company secrets and other confidential information with outsiders.[120] As a matter of course, an exception applies where disclosure of the information is needed to comply with a legal mandate or otherwise serves the corporation's best interests. A case in point is allowing a due diligence review by a potential acquirer or major investor, provided that the corporation has an interest in being acquired or attracting a new shareholder.[121] It is the responsibility of the executive board to define the corporation's best interests and, therefore, to decide whether the information should be revealed, and to whom.[122] Letting management be ensnared in a battle with activist shareholders only because the latter lack certain key information hardly benefits the corporation. As a consequence, fiduciary duties – like insider trading laws – permit the executive board to disclose relevant information to allow activists to evaluate the corporate position and strategy under exceptional circumstances and provided that a proper confidentiality agreement is in place.

Giving activists privileged access to company secrets also raises an issue of equal treatment because other, less powerful shareholders are foreclosed from receiving the same information. In addition to a general equal treatment requirement on behalf of shareholders,[123] German law contains a special – and somewhat curious – regime for equal access to information: The Stock Corporation Act compels management to disclose, upon request, in the shareholders meeting any information that has previously been given to a shareholder in this capacity. The statute expressly precludes the objection that divulging the information would harm the company.[124] The relevance of the provision is limited because the request has to identify the information that was given to the other shareholder; management cannot be asked to substantiate whether such revelation took place.[125] Leaving aside the practical difficulty of asserting the right, it seems inconsistent to allow selective disclosure

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obligation on the part of the recipient, the issuer is required to immediately publicize the information, Art. 17 para. 8 MAR.

[120] § 93 para. 1 sent. 3, § 116 SCA.

[121] See J. KOCH, in: Hüffer/Koch, Aktiengesetz (13th ed., Munich 2018) § 93, para. 32. But see M. LUTTER, Due diligence des Erwerbers beim Kauf einer Beteiligung, Zeitschrift für Wirtschaftsrecht 1997, 613, 617 (requiring an overwhelming interest in taking advantage of a unique business opportunity).

[122] See BGH, 16 April 2016, XI ZR 108/15, Neue Juristische Wochenschrift 2016, 2569, para. 35 (referring to the executive board as the "master of company secrets"); BGH, 5 June 1975, II ZR 156/73, *Bayer AG,* BGHZ 64, 325, 329 (considering the executive board's authority but confining it to actual confidentiality needs).

[123] § 53a SCA. See also § 48 para. 1 no. 1 STA (formerly § 30a para. 1 no. 1 STA).

[124] § 131 para. 4 sent. 1, 2 SCA.

to individual shareholders under a confidentiality agreement and then, as a consequence of this release, to require full disclosure to all shareholders. To avoid this unfortunate result, a better reading of the statutory duty is that it attaches only if making the information available outside the shareholders meeting was unjustifiable under the equal treatment principle.[126] The duty is better seen as a remedy for a violation of equal treatment. Sharing information with activists in the best interests of the corporation should not imply spilling the beans.

3. *Activists' Influence on Management*

Beside information leakage to activists, a second major concern is to which degree management can open itself to pressure from activists without surrendering its responsibility under the corporate constitution and compromising its fiduciary obligation towards the corporation and all of its shareholders.

a) *Role of the supervisory board*

With regard to shareholder involvement, a vivid recent debate concerns the role of the supervisory board and specifically whether it can – and perhaps should – engage in a conversation with investors.[127] The German two-tier system necessitates a separation of powers between the supervisory and the executive board.[128] At first blush, the executive board figures as the supreme corporate organ: The Stock Corporation Act's very first provision on the corporate constitution vests it with the power to "govern" or "direct" the

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[125] D. KUBIS, in: Goette/Habersack/Kalss, Münchener Kommentar zum AktG (4th ed., Munich 2018) § 131, para. 158. But see BayObLG, 17 July 2002, 3Z BR 394/01, Neue Zeitschrift für Gesellschaftsrecht 2002, 1020, 1021 (enforcing a request to state "which information and details" about the company's valuation were provided to a particular major shareholder).

[126] D. VERSE, Der Gleichbehandlungsgrundsatz im Recht der Kapitalgesellschaften (Tübingen 2006) 510–512; H. FLEISCHER, Investor Relations und informationelle Gleichbehandlung im Aktien-, Konzern- und Kapitalmarktrecht, Zeitschrift für Unternehmens- und Gesellschaftsrecht 2009, 905, 520. Contra G. BACHMANN, Kapitalmarktpublizität und informationelle Gleichbehandlung, in: Grundmann et al. (eds.), Festschrift für Eberhard Schwark (Munich 2009) 331, 332.

[127] See K. HOPT, The Dialogue between the Chairman of the Board and Investors: The Practice in the UK, the Netherlands and Germany and the Future of the German Corporate Governance Code Under the New Chairman, ECGI Law Working Paper No. 365/2017, available at SSRN: <https://ssrn.com/abstract=3030693> (providing an overview of the German debate in English).

[128] On the German two-tier system, see generally K. HOPT, The German Law of and Experience with the Supervisory Board, in: Veil/Gao, Foreign Investments on Chinese Capital Markets (Tübingen 2017) 121. See also section 3 German Corporate Governance Code (2017), available at <https://www.dcgk.de/en/home.html> (last visited 2 March 2019).

corporation under its own responsibility, distinguishing this strategic leadership from the more routine "management" of the corporation that is also entrusted to the executive board.[129] The supervisory board, on the other hand, is excluded from corporate management.[130] Its main powers consist in appointing or – on rare occasions – dismissing managing directors, setting their compensation, and supervising their conduct.[131] Yet as a matter of course, there is no bright line between management and monitoring the managers. The responsibility for retaining the most able managers and overseeing the exercise of their duties inevitably requires a judgment on managerial decision-making. German law further blurs the distinction by charging the supervisory board with not only a hindsight evaluation of management performance but also a forward-looking monitoring and advisory role.[132] Emphasizing the active involvement of the supervisory board has been a long-run trend in German corporate law in the decades past.[133] In consequence of this development, many now consider both boards to be entrusted with determining the strategy and "governing" the stock corporation.[134]

The supervisory board's rise to leadership forms the background for the narrower debate on whether it has the right to interact directly with activist investors. The more conservative commentators insist on the prerogative of

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[129] Compare § 76 para. 1 SCA ("governance" or "Leitung" of the corporation) to § 77 para. 1 SCA ("management" or "Geschäftsführung"). The English translation furnished by the Federal Ministry of Justice, *supra* note 88, misses this difference.

[130] § 111 para. 4 sentence 1 SCA.

[131] § 84 paras. 1, 3 SCA (appointment of managing directors and dismissal for cause); §§ 87, 112 SCA (compensation and service contract); § 111 para. 1 (supervision of executive board). The drafters of § 84 para. 3 SCA consciously introduced the for-cause requirement to prevent the supervisory board from wresting control from the executive board, see H. FLEISCHER, Zur Abberufung von Vorstandsmitgliedern auf Druck Dritter, Deutsches Steuerrecht 2006, 1507, 1508.

[132] § 90 para. 2 no. 4 SCA (duty of executive board to inform the supervisory board of significant transactions ahead of time to give the latter an opportunity to comment on the transaction); § 111 para. 4 sent. 2–5 SCA (mandatory list of transactions that require supervisory board approval).

[133] See, e.g., BGH, 25 March 1991, II ZR 188/89, *Deutscher Herold,* BGHZ 114, 127, 129–130 (recognizing for the first time an advisory duty of the supervisory board); BGH, 6 November 2012, II ZR 111/12, *Piëch/Porsche,* Zeitschrift für Wirtschaftsrecht 2012, 2438, 2439 (duty of supervisory directors to assess independently the risks involved in major transactions); section 5.1.1 German Corporate Governance Code, *supra* note 128) ("regularly advise and supervise the Management Board"). The requirement to subject certain transaction to supervisory board approval, *supra* note 132) was introduced only in 2002. See generally J. LIEDER, The German Supervisory Board on Its Way to Professionalism, German Law Journal 11 (2010) 115.

[134] See J. KOCH, Der Vorstand im Kompetenzgefüge der Aktiengesellschaft, in: Fleischer/Koch/Kropff/Lutter, 50 Jahre Aktiengesetz, Zeitschrift für Unternehmens- und Gesellschaftsrecht, Sonderheft 19, 2016, 65, 77–81 (summarizing the positions).

the executive board in shaping the corporate strategy. Although the supervisory board may have become more active and more involved in strategy development over time, it need not follow that it has authority to speak with outsiders about these matters.[135] Others claim that the power of a corporate organ to decide – or to participate in decision-making – entails a right to explain and discuss one's position with the relevant stakeholders and the public.[136] When the supervisory board is involved in shaping and implementing the corporate strategy, the argument goes, it should be able to explain it to major investors and to learn their views.[137] Yet even those advocating direct exchanges between the supervisory board and the shareholders respect the executive board's prerogative over strategy, notably the exclusive right to initiate strategy changes. As it is in the interest of the corporation to speak "with one voice", the supervisory board must exercise caution to not undercut the executive board's communication with investors and the market.[138]

For practical matters, it appears that the more expansive reading of supervisory board authority is being adopted in corporate Germany. Since 2017, the German Corporate Governance Code has contained a "suggestion" that the chairperson of the supervisory board "should be available – within reasonable limits – to discuss Supervisory Board-related issues with investors."[139] A working group composed of academics, corporate directors, investors, and advisers has drawn up "Guiding principles for the dialogue between investors and German supervisory boards" to advise on the appropriate scope of such

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[135] See the nuanced argument made by J. KOCH, Investorengespräche des Aufsichtsrats, Die Aktiengesellschaft 2017, 129, 131–133 (external communication only where executive board lacks ability to provide the information demanded by investors, especially regarding the appointment and compensation of managing directors). See also M. HABERSACK, in: Goette/Habersack/Kalss, Münchener Kommentar zum AktG (5th ed., Munich 2019) § 111 AktG para. 67 (likewise); B. GRUNEWALD, Der Einfluss des Aufsichtsrats auf die Geschäftsführung – was ist erwünscht, was ist erlaubt?, Zeitschrift für Wirtschaftsrecht 2016, 2009, 2010–11 (reserving all matters of strategic leadership to the executive board).

[136] H.-C. HIRT/K. HOPT/D. MATTHEUS, Dialog zwischen dem Aufsichtsrat und Investoren, Die Aktiengesellschaft 2016, 725, 733–734; H. FLEISCHER/L. BAUER/T. WANSLEBEN, Investorenkontakte des Aufsichtsrats: Zulässigkeit und Grenzen, Der Betrieb 2015, 360, 363–365. See also BGH, 5 June 1975, II ZR 156/73, *Bayer AG,* BGHZ 64, 325, 331 (recognizing a corporate interest, in the context of employee representative on the supervisory board, in allowing directors to dispel misunderstandings or rumors and to improve public perceptions of the corporation).

[137] HIRT/HOPT/MATTHEUS, *supra* note 136, 734; FLEISCHER/BAUER/WANSLEBEN, *supra* note 136, 364 (but emphasizing the monitoring, as opposed to strategy-shaping, role of the supervisory board).

[138] HIRT/HOPT/MATTHEUS, *supra* note 136, 735; FLEISCHER/BAUER/WANSLEBEN, *supra* note 136, 365–366.

[139] Section 5.2 para. 2 German Corporate Governance Code, *supra* note 128.

conversations.[140] By promoting a "stewardship" responsibility of institutional investors, the 2017 recast of the EU's shareholder rights directive and its ongoing implementation further strengthens the legal basis for direct shareholder engagement with the supervisory board.[141]

Institutional investors seem to demand more access to the supervisory board.[142] Direct interactions make the supervisory board more accountable to the other party: The ability to ask questions, advance preliminary views, and learn from responses ultimately allows one to make fine-tuned requests that are harder to reject because valid objections should have come up during the conversation. Such pointed demands come from significant shareholders with much sway in corporate elections. If only the executive board were to talk with them, investors would wield less power over the supervisory board and, as a consequence, over the managing directors themselves. Viewed from this angle, denying investors access to the supervisory board is a legal strategy to strengthen management independence towards shareholders. The German debate seems not to have addressed this underlying policy issue – likely because accountability to the stock market continues to be seen as highly desirable.

b) Management autonomy

When activists have built a stake and secured sufficient support from other investors to pose a plausible threat, both sides will want to avoid a costly and risky battle for control. The time has come to negotiate and perhaps to agree on changes in corporate policies and the management team. Research from the U.S. records a considerable number of "settlements" between activists and management.[143] Side-deals to appease vociferous investors can be suspicious for various reasons. An obvious concern is "greenmailing" – manage-

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[140] Not accidentally, the authors of HIRT/HOPT/MATTHEUS, *supra* note 136, also participated in the working group.

[141] The current draft of the implementation bill requires institutional investors and asset managers to describe their engagement policy with portfolio companies, including on exchanges with "corporate organs" (plural!), see § 134b para. 1 no. 3 SCA as introduced by the draft, Bundestag, printed paper 19/9739.

[142] Without exception, all contributions to the debate admit that the driving force has been (foreign) investors. On the resulting convergence towards the more common one-tier model see, e.g., G. BACHMANN, Dialog zwischen Investor und Aufsichtsrat, in: Gesellschaftsrecht in der Diskussion 2016 (2017) 135, 154–155 (also for another balanced assessment of the debate).

[143] L. BEBCHUK/A. BRAV/W. JIANG/T. KEUSCH, Dancing with Activists, Working Paper, 2017, available at SSRN: <https://ssrn.com/abstract=2948869>, Table 1 and Table 5 (documenting agreements in 17–20% of activist engagements 2008–2011, typically over changes in the composition of the board). For Germany, see M. SCHOCKENHOFF/J. CULMANN, Shareholder Activism in Deutschland, Zeitschrift für Wirtschaftsrecht 2015, 297, 300–305 (discussing possible agreements with activists under German law).

ment paying off activists from the corporate coffers, typically by acquiring their shares at a premium. The latter technique is almost certainly illegal for a German corporation,[144] as would be any disbursement of wealth to individual shareholders outside an officially declared dividend, which would have to be paid equally to all shareholders.[145] Subtler forms of value transfers can be harder to spot and to deter.

Apart from greenmailing of all stripes, it could seem questionable to allow a subset of shareholders to obtain a sustained and possibly concealed grip on the corporation. This relates to another contemporary debate in German corporate law about the abdication of managerial authority. As mentioned before, the power to "govern" the corporation "on its own responsibility" is vested in the executive board.[146] Neither the supervisory board nor the shareholders meeting must interfere with the executive board's prerogative.[147] The doctrine of "prohibition of precommitment" *(Verbot der Vorwegbindung)* also precludes the executive board from surrendering its constitutional power by voluntary agreement.[148] The traditional prohibition has been tested in certain control transactions, including the acquisition of minority positions. In such instances, investors often request, and corporations accede to, "business combination agreements" or similar agreements in order to ensure the execution of complex transactions. In the course of such arrangements, management may commit to abstaining from soliciting competing offers or issuing new shares, to compensating the investor's expenses if the deal fails, to pursuing a certain business strategy, or to proposing investor nominees for election to the supervisory board.[149] Because the ability to commit to a course of

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[144] See the restrictions on the acquisition of own stock in § 71 SCA. Buying off activists can hardly be justified by averting "serious and imminent harm" from the corporation, as § 71 para. 1 no. 1 SCA would require. Even based on authorization by the shareholders meeting, management would have to offer a premium equally to all shareholders, see § 71 para. 1 no. 8 sent. 3 and 4 SCA.

[145] See the principle of preservation of corporate resources (Prinzip der Vermögensbindung) enshrined in § 57 paras. 1, 3 SCA.

[146] See again § 76 para. 1 SCA.

[147] For the shareholders meeting, see § 119 para. 2 SCA (no resolution on management matters other than at the initiative of the executive board).

[148] A seminal reference is M. LUTTER, Zur Vorbereitung und Durchführung von Grundlagenbeschlüssen in Aktiengesellschaften, in: Festschrift für Hans-Joachim Fleck (Berlin/Boston 1988) 169, 184–185 (arguing against a binding abdication of the executive board's responsibility but excluding commitments to third parties). Related doctrines in common law jurisdictions are referred to as the "no-fettering rule" (UK) and the prohibition of "abdication of authority" (US), see H. FLEISCHER, Zur Unveräußerlichkeit der Leitungsmacht im deutschen, englischen und US-amerikanischen Aktienrecht, in: Festschrift für Eberhard Schwark (Munich 2009) 137, 139, 144.

[149] See D. WEBER-REY/M. REPS, Ankerbeteiligungen: Chancen für die Corporate Governance, Rechtsrahmen und Investorenvereinbarungen, Zeitschrift für Unternehmens- und

action can benefit the corporation or its shareholders, such as by attracting higher bids in control transactions, many commentators are prepared to soften the ban on obligations regarding the executive board's power to "govern" – as opposed to "manage" – the corporation.[150] One prominent view proposes to retain the prohibition but to narrow its scope. A commitment over a moderate timespan is said to be the exercise, rather than the abdication, of discretion.[151] An alternative position considers only encroachments on shareholders' rights, specifically the ultimate control over who governs the corporation.[152] A more radical proposal is to abolish the prohibition altogether and to invoke only directors' fiduciary duties against excessive commitments.[153]

Management need not enter into legally binding agreements with activist shareholders.[154] A truce can – and likely often will – take the form of an informal understanding. Therefore, the relevant question is whether the "prohibition of precommitment" or equivalent restrictions resulting from fiduciary duties extend to promises made to placate shareholders who threaten to wage war against management. It is often argued that directors must resist any act that they themselves consider contrary to the best interest of the company.[155] Announcing this principle is one matter, effectuating it a different one. Directors will strongly perceive it in their own private interest to avoid a battle with activists that could result in a resounding defeat and their individual displacement from a lucrative position of power. In choosing between their own judgment and the demands of activists, they face a pronounced conflict of interest. At the same time, addressing the conflict poses insurmountable difficulties. The only viable option would consist of withdrawing the protection of the business judgment rule and exposing directors to liability under a substantive fairness review. Such a strategy would be forbiddingly unattractive: In deter-

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Gesellschaftsrecht 2013, 597, 619–626 (summarizing possible undertakings in investment agreements); J. REICHERT, Business Combination Agreements, Zeitschrift für Unternehmens- und Gesellschaftsrecht 2015, 1, 6–9 (likewise for business combination agreements).

[150] Compare again § 76 para. 1 SCA and § 77 para. 1 SCA and see note 129 above. Under the conventional analysis, the prohibition attaches only to the strategic "governance" of the corporation.

[151] FLEISCHER, *supra* note 148, 151; REICHERT, *supra* note 149, 23.

[152] T. KUNTZ, Grundlagen und Grenzen der aktienrechtlichen Leitungsautonomie, Die Aktiengesellschaft 2016, 101, 107–109, 112–113 (including also the power to delegate decisions to management such as in the case of authorized capital).

[153] KOCH, *supra* note 134, 95–100 (but listing specific statutory restrictions of management powers that, if exceeded by a commitment, result not only in a breach of fiduciary duty but also in the agreement being rendered invalid).

[154] But see SCHOCKENHOFF/CULMANN, *supra* note 143 (suggesting that binding agreements occur).

[155] See, e.g., for the supervisory board's decision to dismiss a managing director after a no-confidence vote at the shareholders meeting, FLEISCHER, *supra* note 131, 1513; for its right to nominate supervisory directors WEBER-REY/REPS, *supra* note 149, 625.

mining fairness, courts would have to pit their own judgment against that of activists.[156] If activists are a force for the better at least on average, one is hard pressed to believe that courts are well positioned to compare the business strategies of incumbent management with that of the activists. Also, a fairness review would create significant uncertainty for managers. The threat of personal liability would become a credible argument for managers to reject any changes to their own original plans, shielding them against activist influence generally – which is unlikely to strike the best balance.

V. Conclusion

Shareholder activists have become major players in the contemporary landscape of corporate governance. Germany is no exception. Its financial and legal environment has proved amenable to activism and allowed a considerable number of campaigns to succeed. This accords well with the available economic theory and evidence that suggests greater accountability to shareholders can yield benefits – but this same evidence cannot rule out potential adverse effects on the long-run performance of certain firms as well as on stakeholders other than equity investors. The law would have little difficulty in suppressing or restricting shareholder activism across the board if this were considered desirable. It is a far more challenging task to discern value-enhancing, beneficial instances of activism from destructive ones that sacrifice long-term corporate success and stakeholder welfare. Law and regulation seem poorly equipped to draw such a distinction with any degree of confidence. The most promising strategy seems to be to leave the decision to shareholders. As is often the case in corporate governance, the appropriate role of the law may be a limited one.

[156] The Delaware courts have famously developed an "intermediate" standard of review in hostile takeovers where management is likewise conflicted because it is at risk of losing its position, see *Unocal v. Mesa Petroleum,* 493 A.2d 946, 954–956 (Del. 1985); *Revlon v. MacAndrews & Forbes Holdings,* 506 A.2d 173, 180 (Del. 1986). In the present context, directors could be too inclined to accommodate activists, rather than opposing them.

Shareholder Activism in Japan

Chick Sexing or Tautology?

Akira Tokutsu

I. Who is an Activist? What is Shareholder Activism?

In all developed capitalist countries, shareholder activism is currently one of the hottest topics in corporate governance. Drawing particular attentions is the discussion as to whether activists are myopic and obsessed with the short-term. Some practitioners have criticized shareholder activism, arguing that their short-termism sacrifices firms' long-term value.[1] By contrast, L. A. Bebchuk has found that activism improves firm performance (as evidenced by the measurements of return on asset [ROA] and Tobin's Q) – so much so that he sees activism as a good tool for business.[2]

To date, most studies have dealt with US-listed companies; there has not yet been much research done concerning Japanese activism.[3] One reason for

[1] WACHTELL, LIPTON, ROSEN & KATZ, Hedge Fund Activism and Long-Term Firm Value, 24 November 2015, <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.24990.15.pdf>.

[2] L. A. BEBCHUK/A. BRAV/W. JIANG, The Long-Term Effects of Hedge Fund Activism, Columbia Law Review 155 (2015) 1085–1156, 1098–1099.

this lack of attention is that much of the activism in Japan has been suppressed or hidden since 2008.

In Japan, there were two prominent activists more than ten years ago: (1) M&A Consulting along with some related hedge funds (aka the "Murakami Funds") and (2) Steel Partners. They each held block shares of certain companies and in the 2000s drew a lot of attention.[4] However, in 2007 Steel Partners failed in its attempted takeover of Bulldog Sauce Co. due to the use of the takeover defense known as the "poison pill", a measure that gives shareholders other than the buyer the right to purchase more shares at a discount.[5] At Murakami Funds, the founding manager was arrested for insider trading in 2006.[6] Just after these two events, there were some disputes between activists and management, with the result that hedge funds have since 2009 largely worked to avoid drawing attention to themselves.[7] Some studies have addressed the influence that shareholder activism has had on firm value and performance during this period, mainly in the first decade of this century.[8] For instance, a former researcher who analyzed fund performance between 2001 and 2008 argues that activists' actions and resulting returns have correlated negatively since 2004.[9] After the two events outlined just above, the focus on activism in Japan has diminished.

Despite the above, there is another larger obstacle to analyzing the impact of shareholder activism – namely, we cannot define an "activist" clearly. What is shareholder activism? Who is an activist? These are questions that cannot be neatly answered. After the exits of these two prominent funds, hedge funds still hold stock in Japanese companies, but they have been less inclined to undertake confrontational actions against management so conspicuously.[10] Can we still refer to these funds as activist entities?

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[3] Several works have analyzed the impact of shareholder activism in Japan. See K. UCHIDA/P. XU, US Barbarians at the Japan Gate: Cross Border Hedge Fund Activism, Bank of Japan Working Paper Series, no. 08E-3 (2008), <https://www.boj.or.jp/en/research/wps_rev/wps_2008/wp08e03.htm/>; Y. HAMAO/K. KUTSUNA/P. P. MATOS, U.S.-Style Investor Activism in Japan: The First Ten Years, 5 February 2011, <https://ssrn.com/abstract=1785281>. Some research has been published in Japanese. See, K. INOUE/H. KATO, Activist Fund no Kozai, Hitotsubashi Daigaku Keizai Kenkyu 58, no. 3 (2007) 203–316.

[4] J. BUCHANAN/D. HEESANG CHAI/S. DEAKIN, Hedge Fund Activism in Japan (Cambridge and New York 2012) 154–158 [Murakami Fund], 174–180 [Steel Partners].

[5] BUCHANAN et al., *supra* note 4, 212–220.

[6] BUCHANAN et al., *supra* note 4, 158.

[7] BUCHANAN et al., *supra* note 4, 282–293.

[8] BUCHANAN et al., *supra* note 4, 199–211 [119 companies between 2001–2007]; INOUE/KATO, *supra* note 3, 206–214 [204 companies invested in by six activist funds between 2000 and 2006].

[9] BUCHANAN et al., *supra* note 4, 199–211.

[10] BUCHANAN et al., *supra* note 4, 282–293.

Intuitionally, we have in many cases a consensus as to which institutional investors are activists and which are not. For instance, we do not think that the main Japanese banks or insurance companies are activists, though they hold a large amount of stock in listed Japanese companies. Yet the criteria for activism are not clear. If we define activists as those institutional investors who often or sometimes exercise shareholders' rights or who take some other action regarding companies or their management, the main Japanese banks can be called activists because they have been said to influence the decisions made by management officials.[11]

In the context of the US, Bebchuk considered as activists those investors filing a Schedule 13D, an SEC filing that must be submitted within ten days after acquiring more than 5% of the stock of a public company, but he excluded banks, insurance companies, and mutual funds from his definition.[12] Yet apart from Schedule 13D filers in US securities law, he could have, in theory, included many other institutional investors. Similarly, we can ask why Bebchuk excluded banks and insurance companies.

From a non-specialist perspective, it seems similar to the chicken-sexing test: the result of the determination is clear, but the mechanism is unclear. Or, it seems based on a rule of thumb, not on a theoretical distinction. Sorting activists can be seen as nothing more than tautology: Activists are investors whom authors would like to name as activists.

Before analyzing the impact of shareholder activism, we must address the question of how we define shareholder activism. If the definition is not clear, the analysis will be useless as we cannot detect whether an actor is or is not behaving in a myopic fashion without first determining whether the actor is an activist or not.

In 2018, activist investors were said to return to Japan;[13] I argue, however, that the situation remains unchanged.

II. Two Anecdotal Cases

The myopia hypothesis associated with shareholder activism – namely, the theory that activists are myopic and obsessed with the short-term – has not yet been verified in Japan. Nevertheless, many Japanese analysts are attracted to the hypothesis. Regarding activists' alleged return to Japan, the criticism of

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[11] M. Aoki/H. Patrick (eds.), The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies (Oxford/New York 1994).

[12] BEBCHUK et al., *supra* note 2, 1098–1099.

[13] D. MARUYAMA, Activist Investors Flock back to Japan's Stock Market, Nikkei Asian Review, 15 February 2018, <https://asia.nikkei.com/Business/Markets/Equities/Activist-investors-flock-back-to-Japan-s-stock-market>.

short-termism has also returned to the country.[14] The critique goes well with traditional Japanese beliefs about corporations, stakeholder theory, and employee-oriented theory, though it should be observed that long-term benefit is not focused on employee value, but rather on shareholder value. Protecting employees can lead to long-term value for shareholders.

In the legal studies field, by contrast, shareholder primacy is preferred. Short-termism as a phenomenon does not receive much support from corporate law scholars, even in Japan. However, as is the case in the US, some practitioners support the short-termism hypothesis with reliance on anecdotal evidence.

1. Third Point

Sony – Third Point LLC is a hedge fund established under US law. In May 2013, it bought 7% of Sony's stock and proposed Sony's spin-off of the entertainment division.[15] In the end, Sony rejected the original proposal but implemented some other strategies so as to retreat from personal computer (PC) production and spin off its television business. This restructuring increased Sony's stock value, and Third Point succeeded in realizing a 20% profit from the sale of the stock in July 2014.[16]

In this case, the decision to close Sony's PC production division could possibly be seen as short-termism, as it would lead to a sacrifice of long-standing value. However, there was no evidence that continuing the PC business would have been profitable. At the very least, Sony's stock price rose. This can be seen as a sign of an efficient decision; for this reason, we cannot consider this evidence of short-termism.

Fanuc – Fanuc, an industrial robot maker, was Third Point's next target. Fanuc was famous for its high profitability; its operating profit ratio on sales was 40%. Fanuc was also famous for preferring not to disclose much information to investors. Based on these facts, Fanuc was seen as an employee- and consumer-oriented company.

In January 2015, Third Point disclosed the purchase of Fanuc stock and stressed that Fanuc itself should have repurchased this stock and distributed a free cash flow equaling 1 trillion Yen (8.7 billion US-Dollars) to sharehold-

[14] M. KAJIWARA, Increasing Intimidating Long-term Shareholders, Nihon Keizai Shinbun, 18 May 2018, 6.

[15] "U.S. Hedge Fund raises Sony Stake", Japan Times, 19 June 2013, <https://www.japantimes.co.jp/news/2013/06/19/business/corporate-business/u-s-hedge-fund-raises-sony-stake/>.

[16] "Third Point Sells Sony, Takes New Stakes in eBay, Alibaba", Japan Times, 22 October 2014, <https://www.japantimes.co.jp/news/2014/10/22/business/corporate-business/third-point-sells-sony-takes-new-stakes-in-ebay-alibaba/>.

ers. Fanuc rejected the repurchase plan and decided to build a new industrial plant worth 100 billion Yen (870 million US-Dollars). However, Fanuc increased its dividend ratio.[17] This meant that Fanuc heeded the call by Third Point to a certain extent.

Some have seen this as an instance of an employee- and consumer-oriented company being beaten by short-termism. In this case, however, the activists helped to reduce free cash flow and agency costs. This can be seen as improving social welfare.

Seven & I – In October 2015, Third Point acquired the stock of Seven & I Holdings Co., the largest retailing company in Japan. Third Point called on Seven & I to downsize its general merchandise business to improve profitability.[18]

In March 2016, there was a rumor that the Seven & I CEO would be ousted by the former CEO, who was also the board of director chairman, and that this former CEO would try to name his son as the next CEO. At the end of March, Third Point strongly protested against this succession plan and, ultimately, the board rejected it.[19]

This sequence of events demonstrated how an activist stance could succeed in influencing the designation of a firm's CEO. Additionally, Seven & I was encouraged to continue downsizing its retailing business. Further, we have no evidence that this restructuring was based on short-termism.

2. Glaucus Research Group

Glaucus Research Group (Glaucus) is a company engaged in two different businesses. One is that of analyzing capital markets and listed companies. The other is focused on investment activities. Glaucus has published several reports and holds some equities or positions related to these equities.

In June 2016, Glaucus published a report criticizing the accounting of the Itochu Corporation, the third-largest trading house *(Shosha)* in Japan. It claimed that Itochu did not book a 153.1 billion Yen (1.3 billion US-Dollars) loss of Colombian coal mining assets.[20] However, Glaucus held short-sell positions in regards to Itochu's stock. Therefore, the subsequent decline of

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[17] "Fanuc to Increase Shareholder Returns after Third Point Takes Stake", Wall Street Journal, 13 March 2015, <https://www.wsj.com/articles/fanuc-to-increase-shareholder-returns-after-third-point-takes-stake-1426205513>.

[18] "Daniel Loeb's Third Point Takes Stake in Japan's Seven & I", Financial Times, 27 October 2015, <https://www.ft.com/content/a114683a-7c58-11e5-98fb-5a6d4728f74e>.

[19] "Daniel Loeb Presses Japan's Seven & I on Succession Plans", Financial Times, 28 March 2016, <https://www.ft.com/content/5e06bb3c-f490-11e5-96db-fc683b5e52db>.

[20] "Short-seller Glaucus Takes Aim at Japan's Itochu", Financial Times, 27 July 2016, <https://www.ft.com/content/7ddd28de-538f-11e6-befd-2fc0c26b3c60>.

Itochu's stock price led to profits for Glaucus. Itochu protested against the report and asserted that it had taken proper accounting measures.[21]

This case is sometimes referred to as evidence of activists' short-termism.[22] Indeed, Glaucus had an economic incentive in decreasing Itochu's stock price with its reporting action. However, Glaucus was not a shareholder, just a short-seller. Thus, its conduct had no bearing on shareholding or short-termism, though it could be seen as evidence of the need to regulate an analyst's actions in the capital market.

3. Implications from New Cases Involving Activists

The facts outlined above do not give evidence that activism is based on myopia. Therefore, even cases arising following the alleged return of activists to Japan do not support the myopia hypothesis. Nevertheless, Japanese firms have employed some instruments to respond to short-termism.

The more important consideration is that these cases are regarded as ones in which "activists came back." It would seem that the definition of an activist depends in part on the nature of the underlying fund.

III. The Definition of "Activists"

Learning from instances in the 2000s of prominent activists and new cases, let us consider the elements common among activists. An activist must be of two natures: First, activist investors influence the decisions of a firm's managers. Though funds have admittedly tried to exert influence on firms' management, traditionally the main banks of Japan have also done the same thing.

Second, activists focus purely on investors' benefits rather than trading benefits or other benefits. Generally speaking, the main bank may assume one of two different positions when dealing with businesses: lender or shareholder. The main bank exercises its shareholder's rights (e.g. voting rights) to promote not only the shareholders' benefit but also the lender's benefit. The lender benefit is not one aligned with the interests of other shareholders. Insurance companies, especially life insurance companies, also tend to hold many shares and exercise their rights to win group insurance contracts with companies. Such contracts are said to cater to the "private benefit" of shareholders.[23]

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[21] "As Commodities Fell, Accounting Change Kept Itochu's Bottom Line Steady", Wall Street Journal, 4 October 2016, <https://www.wsj.com/articles/as-commodities-fell-accounting-change-kept-itochus-bottom-line-steady-1475584124>.

[22] K. SEKIGUCHI, Cornered Short-sellers, Nihon Keizai Shinbun, 18 August 2016, 16.

[23] Traditionally, the private benefit of shareholders seems only to apply to controlling shareholders. See, S. J. GROSSMAN/O. D. HART, One Share-One Vote and the Market for Corporate Control, Journal of Financial Economics 20 (1988) 175–202; O. D. HART, Firms,

By contrast, activists focus – or "should" focus – purely on investors' interests. In this light, Glaucus should be excluded from the ranks of activists because it tried to promote its interests as a short-seller and not as a shareholder.

IV. Shareholder Ownership and Firm Performance

Following the second aspect of activism outlined above, whereby no private benefit is sought, we can divide institutional shareholders into two types. First, we can consider outside institutional shareholders. Activist investors should be included in this group. The other is inside institutional investors, including banks and insurance companies. They usually have good relationships with firms' management officers because these companies are their customers. The interests associated with these relationships are of a private benefit nature. Shareholders who are themselves corporations also fall into the insiders category because the business relationship among their managers is in many cases the motivation behind many shareholding decisions. Shareholdings, or in some cases cross-shareholdings, would prove a commitment to the long-term relationship between corporations. However, individual investors usually belong to the outside investors group.

The impact of outside institutional shareholders has been measured by earlier research on ownership structures. Traditionally, insiders outnumbered outsiders in Japan. However, the ratio is reversed today. This can be seen as one of the signs of a convergence toward an Anglo-Saxon system or shareholder primacy.[24]

Private benefits could in some cases lead to inefficient results because of agency costs and entrenchment effects. However, in other cases private benefit is a great tool for solving collective action problems associated with dispersed ownership structures (e.g. free-riders and rational apathy). There is a trade-off between costs and benefits, in theory. Therefore, this problem must be reviewed in empirical studies.

Miyajima et al. showed that the performances of listed subsidiaries were better than independent listed companies, in terms of Tobin's Q and ROA. This research implies that the existence of large shareholders in a corporation could result in monitoring benefits greater than the costs associated with entrenchment.[25] On one hand, Miyajima and Kuroki demonstrated that the

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Contracts, and Financial Structure (New York 1995) 186–209. However, non-controlling shareholders, like business partners, can also reap private benefits.

[24] H. HANSMANN/R. KRAAKMAN, The End of History for Corporate Law, Georgetown Law Journal 2001, 439.

[25] H. MIYAJIMA et al., Economic Analysis of Listing Parent and Subsidiary Companies (in Japanese), in: Miyajima (ed.), *Nihon no Kigyotochi* [Corporate Governance in Japan] (Tokyo 2011), 289–337.

ratio of bank and insurance company shareholdings is negatively associated with a firm's performance. On the other hand, the ratio of business corporation shareholding had no statistically significant impact.[26] These studies imply that there is a difference between bank shareholdings and corporation shareholdings among insiders.

Turning to outside institutional investors, Miyajima and Kuroki (2007) found that shareholding ratios have a positive relationship with a firm's performance. While this finding left unanswered the question of cause and effect, Miyajima and Yasuda (2015) later used a two-stage estimation *(Heckit)* to show that institutional investors do influence a firm's performance.[27]

Today, whether or not a hedge fund can lead to short-termism is a hot topic of research. In Japan, Arikawa et al. (2011) demonstrated that institutional investors have been at the forefront of the increase in R&D investment.[28] This finding was the opposite of that suggested by the short-termism hypothesis.

All of these facts imply that activists, or outside shareholders, promote the value of companies. At the very least, previous studies have not empirically supported the myopia hypothesis.

V. Exercising Shareholder Rights

In addition to typically being outside shareholders, activists have, as mentioned in Section III, another important characteristic: influencing management decisions. In Japan, traditional institutional investors such as banks and insurance companies have not tended to exercise formal shareholders' rights confrontationally against management, in hopes of maintaining good business relationships and exacting private benefits. However, this situation has changed in recent years.

The Japanese Financial Service Agency released a Stewardship Code in 2014 and revised it in 2017.[29] The Code is a soft law mechanism designed to regulate institutional investors. It imposes on institutional investors not only the responsibility for final beneficiaries but also the need for constructive

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[26] H. MIYAJIMA/F. KUROKI, The Unwinding of Cross-Shareholding in Japan: Causes, Effects, and Implications, in: Aoki/Jackson/Miyajima (eds.), Corporate Governance in Japan: Institutional Change and Organizational Diversity, (Oxford/New York 2007) 79–124.

[27] H. MIYAJIMA/T. HODA, Ownership Structure and Corporate Governance – Has an Increase in Institutional Investors' Ownership Improved Business Performance? (in Japanese), Financial Review 2015, 3–36.

[28] Y. ARIKAWA et al., R&D Investment and Fund Raising, Corporate Ownership Structure (in Japanese), in: Miyajima (ed.), *supra* note 25, 341–366.

[29] The 2017 Revised Japanese Stewardship Code is available at <https://www.fsa.go.jp/news/29/singi/20170529/01.pdf>.

engagement with investee companies.[30] "Constructive engagement" is an ambiguous term, but it is clear that the Code expects institutional investors to influence the investee companies' decisions to some extent. Informally, a practitioner in a financial industry has said that the main target of the Code was Japanese insurance companies because, in the past, they never fulfilled their responsibilities to the beneficiaries or policyholders. If traditional institutional investors start to exercise formal shareholder rights to fight management, the motivation for holding shares will also change, it is moving from pursuing a private benefit to asserting a pure investor interest. These facts can be evaluated in light of the Code's requirement that insider institutional investors act as activists.

The Stewardship Code could make the distinction between activists and other institutional investors in Japan less clear.

VI. Responses to (the Illusion of) Short-Termism

1. Practice

Even though the myopia hypothesis regarding activists has not been verified in Japan, many companies have employed certain instruments to respond to shareholder activism. One of the most commonly used instruments is the takeover defense known as the "poison pill." In 2005, Bulldog Sauce Corp. employed a poison pill to beat a takeover bid by Steel Partners. The Japanese Supreme Court affirmed the use of this poison pill.[31] Generally speaking, this decision resulted in hedge funds giving up on hostile takeovers, and the need for a takeover defense correspondingly decreased dramatically.

Today, another instrument for responding to shareholder activism has emerged: the dual-stock structure. Generally speaking, start-up companies use this device to maintain motivation for the founders' firm-specific human capital. In such companies, the firm's value depends greatly on the talent of the founders. Therefore, shareholders must hold onto the founding firm-specific human capital. For instance, founders are often issued "golden shares," shares in a company that give control over a majority of the voting rights.[32]

Lately, more mature companies have begun using this dual-stock structure. Toyota Motor Corp. issued model AA class shares in 2015. This new, unlisted stock is restricted from trading for five years, but its dividend has been stepped up from 0.5% to 2.5% in five years, and shareholders are expected to

[30] Principle 4 of the Stewardship Code.

[31] Supreme Court, 7 August 2007, Min-shu 61 No. 5 (2007): 2215. English translation available at <http://www.ritsumei.ac.jp/acd/cg/law/lex/rlr26/case.pdf>.

[32] The most prominent case is Cyberdyne's golden shares for the founder. See, K. TOSHIMA, Cyberdyne's Dual-Class IPO, International Financial Law Review 2015, 43.

hold it throughout the period. This stock is designed to carry the same voting rights as common stock so as to improve long-term shareholder value.[33]

Japan does not have a Florange Law, which promises extra voting power to those owning stock for more than two years, as is the case in France.[34] However, in practice, the largest companies use a similar tool to combat short-termism, though there is no evidence of activist myopia.

2. Rules

Unlike the practice of companies, the government has not adopted any specific regulations regarding activist behavior. However, general regulations sometimes serve the role of regulating activists. The rules on substantial shareholding disclosure and the procedure for hostile takeovers are examples. During the legislative process in connection with the Company Act Reform 2014, there was a proposal to suspend the voting rights of shareholders who violated securities regulations such as the substantial shareholder disclosure regulation; however, the proposal was excluded from the bill and not enacted.

Today, a new reform of the Company Act is being debated. One of the reform points is the introduction of a limitation on the number of shareholder proposals. If this rule were enacted, it would serve to restrain shareholder activism. However, the proposed limitation is five or ten proposals. As a general rule, this limitation will not have any effect on shareholder activism because shareholders typically do not propose so many ideas.

VII. Conclusion

In Japan, although shareholder activism is often criticized by practitioners in the financial field, there is no formal evidence supporting the myopia hypothesis. Additionally, the definition of an "activist" is not at all clear. Therefore, this paper has proposed two types of activists to clarify the concept: (1) those seeking no private benefit, and (2) those seeking to influence management decisions. Consistent with these definitions, previous studies do not support the myopia hypothesis in the Japanese context. Additionally, the Stewardship Code has made the distinction between activists and non-activists less clear. For this reason, introducing new regulations exclusively for activists would be nonsensical.

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[33] Reuters, UPDATE 1-Toyota prices 'Model AA' shares at top of range as investors flock, 2 July 2015, <https://www.reuters.com/article/toyota-stocks-pricing/update-1-toyota-prices-model-aa-shares-at-top-of-range-as-investors-flock-idUSL3N0ZI2TO20150702>.

[34] French Commercial Code L225-123 (3).

Shareholder Activism in China

A Special Case for a State-affiliated Service Center for Medium and Small Investors

Ruoying Chen[*]

I. Introduction

One unique feature of China's stock market, which has a market capitalization of about 8.5 trillion US-Dollars,[191] is the prominent position of medium and small investors (referred to as MSIs), which are large in number but each hold a very small portion of shares in listed firms. A recent survey conducted

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[*] For valuable research assistance and telephone interviews with the MSI Center, I thank *Nan Wang,* graduate of Peking University Law School. Unless otherwise noted, all the links referred to in the footnotes were last accessed on 1 July 2019.

[191] That Calm Chinese Stock Market? It's Engineered by the Government, Wall Street Journal, 31 May 2018.

by the stock exchanges in China suggested that 75.1% of investors are MSIs, whose investments have a total value of less than 500,000 Yuan (79,000 US-Dollars).[192] Compared with sophisticated institutional investors, they are particularly vulnerable in the high-volatility market. MSIs usually do not have sufficient information or incentives to exercise scrutiny over listed companies and their controlling parties and executives. The free-riding problem makes it extremely hard for them to organize together to launch an effective challenge when the cost of investigation and litigation is highly concentrated and needs to be paid up front, while the potential benefits of such investigations and litigation are highly dispersed. The difficulties faced by MSIs have provided fertile ground for opportunistic behavior by entities controlling listed firms.

An approach that different jurisdictions use to address this challenge is to have a state regulator. In the United States, class action has proved to be another effective legal tool. Finally, institutional investors and hedge funds have played the role of shareholder activists to promote the interests of minority shareholders and have created deterrence against non-compliance and irregularity in listed firms. In a few jurisdictions in East Asia, the proposed solution has taken a different direction: to create a designated entity as an activist for MSIs.[193] In China, scholars had also proposed setting up an entity specializing in protecting the interests of MSIs.[194] While the state always plays a critical role in various aspects of the stock market and its regulation in China, it also assigns a special role to shareholder activists for protecting the interests of MSIs: the China Securities Regulatory Commission (CSRC) approved the establishment of the China Securities Investor Services Center (the MSI Center[195]) in December 2014. Interestingly, it is incorporated as a limited liability company and has received the designated license for a financial institution officially subject to the administration of the CSRC to provide services on education, law, information and technology for the self-protection of MSIs.

Acting as a shareholder is only part of its mandate, but the MSI Center has taken actions that are common for a shareholder activist. With funding from the state and a special mandate and privileges granted by the CSRC, the MSI has become probably the most effective shareholder activist in China. It is

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[192] See a report on China Daily, dated 16 March 2018 available via its official website: <http://www.chinadaily.com.cn/a/201803/16/WS5aab6fe8a3106e7dcc1421de.html>.

[193] See C. J. MILHAUPT, Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia, The Yale Journal of International Law 29 (2004) 169.

[194] Research Team of the Wuhan University, *Tóuzī zhě bǎohù fǎlǜ zhìdù wánshàn yánjiū* [Research on Improvement of Law for Investor Protection], Zhèngquàn fǎ yuan 1 (2014) 393.

[195] The name of this center in Chinese is *Zhōng zhèng zhōngxiǎo tóuzī zhě fúwù zhōngxīn yǒuxiàn zérèn gōngsī,* see its official website: <www.isc.com.cn>.

hence interesting to present these institutional features and the potential implication of these features regarding its ability to achieve its ultimate policy goal. Other than using existing information about MSIs available in the market, this paper also benefited enormously from the interviews conducted with the MSI Center by the author and the author's research assistant.

In contrast to conventional shareholder activists, the MSI Center also has other mandates, such as to act as a mediator for investors in disputes other than securities fraud litigation, as well as disputes between investors and brokers, etc. Its business scope also includes an open provision which allows it to take on any other business in the future that is authorized by the CSRC. This quasi-governmental nature of the MSI Center has clearly created serious concerns for its independence and its tendency, like any other government entity, to grow its jurisdiction, budget and staff at the same time as or even at the cost of other parts of its mandate.

The rest of the paper is organized as follows: Section 2 introduces the general landscape of shareholder activists in China, especially the special role played by the state. Section 3 presents a few aspects of the institutional design of the MSI Center, compared with a regular shareholder activist. Section 4 introduces the multiple roles played by the MSI Center. Section 5 provides a preliminary evaluation of the performance of the MSI Center and challenges for it to be more effective in promoting the interests of MSIs. A brief conclusion then follows.

1. The Landscape of Shareholder Activism and the Special Role of the State in China

Shareholder activists can be broadly categorized into two camps: profit-seeking ones and stakeholder shareholder activists. The first category usually consists of big institutional investors and hedge funds, who are minority shareholders with a substantial financial stake in listed firms. With rising economic power, institutional investors have also become more and more active and effective in forcing change in listed firms. In 1950, the percentage of total outstanding US equity held by institutional investors was about 6.1%, but this ratio had reached about 70% by 2016.[196] Another type of for-profit shareholder activists are hedge funds, which used to focus only on capital allocation, i.e. dividend and executive pay, but now also care about the overall financial health of listed firms, such as mergers and splits of corporations. With substantial market power, financial capability and expertise, the strate-

[196] P. LOOP/C. BROMILOW/L. MALONE, The Changing Face of Shareholder Activism, Harvard Law School Forum on Corporate Governance and Financial Regulation (2018), available via: <https://corpgov.law.harvard.edu/2018/02/01/the-changing-face-of-shareholder-activism/>.

gies that they pursue are often incremental: one-on-one meetings, proxy contests and media campaigns.[197]

The second category of shareholder activists has a more complicated mix. Some could be non-for-profit organizations pursuing goals other than profit maximization, such as labor protection and improvement of working conditions, consumer protection and environmental protection. Others could be individual investors who possess professional knowledge and experience about corporate governance or financial reporting of listed firms, such as David Webb in Hong Kong.[198]

For the shareholder activists to function to achieve their objective, certain institutions need to be in the place to serve two purposes. The first is to allow shareholders to voice their concerns about listed companies, the controlling entities and the executives of the listed companies. By potentially affecting those entities' reputations, either in shareholder meetings or through media campaigns, shareholder activists could exert a certain amount of pressure, hence hoping to change the behavior of those entities. The second is to bring about real change at the firms, such as in terms of the composition of the board, the firms' rules and policies, and practices of financial reporting, etc. A proxy contest is then required to replace directors, change voting rules or swing the decisions on major transactions.

In China, for various reasons, the conventional shareholder activists are limited in their number as well as in their actions. A recent Ph.D. thesis provided a comprehensive review of institutional investors' shareholder activism and the potential difficulty that they are facing.[199] But such a description is far from unveiling the structural challenge for conventional shareholder activism. The first reason for this lies in the special role that the state plays regarding both investors and listed companies in China. The other reason relates to the legal barriers for shareholder activists to apply conventional methods as seen in a matured stock market.

2. *State Shareholding in Listed Firms and Their Shareholders*

The first reason lies with one feature of the target of shareholder activists: the listed companies, their controlling entities and their executives. Over one third of the listed A-share companies in the two stock exchanges in China are controlled by the state (state-owned enterprises, SOEs).[10] The controlling

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[197] LOOP/BROMILOW/MALONE, *supra* note 196.

[198] See the official website of *David Webb:* <https://webb-site.com>. Also see an earlier report of him in the Financial Times: <https://www.ft.com/content/9d7a49c6-b790-11de-9812-00144feab49a>.

[199] See the unpublished Ph.D. thesis: Y. DING, The Role of institutional shareholder activism in Corporate Governance: A comparative Study of the UK and US and China (2018) 189–217, available at: <http://theses.gla.ac.uk/9002/12/2018DingPhD.pdf>.

shareholders of these companies are either government departments or other SOEs ultimately controlled by the state. Similarly, at least some of the board members and the executives are quasi-public servants, who need to go through special evaluation and promotion procedures within the government before they are formally nominated by the state-shareholder for appointment by the listed companies. Even though there is no direct evidence of the government having an impact on the decisions and actions of shareholder activists targeting SOEs, it is reasonable to hypothesize that regulators and legislators are generally less willing to facilitate such actions by shareholder activists. Therefore, when Indus Capital Partners, a New York-based hedge fund, tried to have a dialogue with China Mobile in the role of a shareholder activist, its peers expressed suspicion.[201]

More importantly, a large majority of the potential shareholder activists, financial institutions in China, are also SOEs. The fact that they are ultimately owned and controlled by the same entity as their targets has reduced those financial institutions' incentives to act as shareholder activists. Even when they do need to communicate with or to bring about actions regarding the target companies, the SOE shareholders have alternative channels which are much more powerful and effective than shareholder activism, such as acting through their shared parent company and parent government entity. Similarly, it could be harmful rather than helpful for an SOE shareholder to try to act as a shareholder activist targeting another SOE target.

To be sure, there are many listed companies that are non-SOEs, which could well be targets for shareholder activists. However, for a few other reasons as set out below, shareholders of these firms may have found it too difficult or too costly to engage in shareholder activism.

3. *Regulation of Non-for-profit organizations and Media*

It is widely recognized in China that it is challenging to set up non-for-profit organizations (NGOs) legally in the first place, and many have taken the form of private firms to obtain a legal presence in China. At the same time, all the legally established NGOs are required to be affiliated with a government department. Under such a regulatory regime, it seems preferable to NGOs to play a role of consultant, advisor and partner rather than an aggressive fighter, either

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[200] As of March 2017, listed companies in China's A-share market were controlled by the state, see a talk given by the then-president of the CSRC, published on Securities Daily, 10 March 2017 and available at: <http://stock.qq.com/a/20170310/004569.htm>. As of 31 December 2016, there were 3052 listed firms in China's A-share market, re data published by the CSRC in March 2017 and available via its official website: <http://www.csrc.gov.cn/pub/zjhpublic/G00306204/zqscyb/201703/t20170308_313308.htm>.

[201] H. SENDER, Western Shareholder Activism arrives in China, Financial Times, 5 July 2016.

towards SOE or non-SOE target firms. While there are plenty of think tanks and research institutions which care a lot about labor conditions, consumer welfare and corporate governance, they are usually not allowed to purchase or to otherwise own stocks, which is a precondition for exercising shareholder activism.

Another difficulty for shareholder activists in China seems to relate to the state control of media. Almost all the conventional media are owned by the state and all of them are closely monitored and regulated by the state. The regulation covers all aspects of operation of these media, such as funding, personnel, and content. Again, it is safe to conclude that such a feature has made it quite a challenge for NGOs or individuals to voice their concerns over listed firms, most of which are SOEs.

4. Corporate Law and Securities Regulation

It is legal to pursue a proxy contest under Chinese corporation law and the mandatory articles of association issued by the CSRC.[202] Since the first reported proxy contest in 2000 regarding a listed A-share company,[203] the practice of proxy contests has developed steadily in China. The usual threshold for shareholders to exercise certain collective rights also exists under China's corporate law and securities regulation, which is no more stringent than in other jurisdictions. However, existing practice rarely involves typical shareholder activists who seek to correct current defects or misbehavior to improve the performance of the listed company. Instead, it has usually involved shareholders who have fought for control of listed firms or individual shareholders who have proposed resolutions to increase bonus shares.[204] When shareholders have tried to fight against controlling entities of listed firms, they have fought for rather narrow and private interests, instead of structural change of a long-term nature that would benefit all shareholders and the integrity of the stock market.

Again, the conventional players of shareholder activism, institutional investors, hedge funds and NGOs, have all seemed to be absent from the landscape of shareholder activism in China. What has emerged to take a similar role of shareholder activist in China, among other roles, is a state initiative which created an entity with approval and a mandate from the CSRC, wholly

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[202] See Art. 107 of China's Corporation Law and Art. 59 of the Mandatory Articles of Association for Listed Companies issued by the CSRC and effective as of 30 September 2016.

[203] See the report by Dapeng Securities Co. Ltd., *Shènglì" zhī zhēng de láilóngqùmài zé gōnggào lā kāi gǔquán zhēngduó de xùmù* [The Fight for the Shares Just Started with an Announcement], Shàngshì gōngsī 1 (2000), available on the official website of People's Daily: <http://people.com.cn/GB/paper87/875/117172.html>.

[204] S. YU, *A gǔ gōngsī dàilǐ quán zhēngjí yìng bù wàng chūxīn* [Proxy Solicitation in the A-Share Market Shall Not Move Away from Its Origin], Zhèngquàn shíbào wǎng, 8 December 2017, available via: <http://www.stcn.com/2017/1208/13818935.shtml>.

owned by various state entities and taking shares in all listed firms on both stock exchanges in China.

II. The MSI Center as a *de facto* Shareholder Activist

Outside of China, there has been a precedent of creating substitutes for conventional shareholder activists to protect the interest of MSIs, especially retail investors. Some of these organizations are purely privately funded non-for-profit organizations, such as the Australian Shareholders Association[205] and the Securities Investor Association in Singapore (SIAS), which is a charity, an Institution of Public Character (IPC), and the largest organized investor group in Asia, with almost 71,000 retail investors as members.[206] In those jurisdictions, capital for these entities is contributed by their respective members as dues. In other jurisdictions, the MSI protection organization was set up or at least funded by the government. A typical example of this is the Securities Investor and Futures Trading Entities Protection Center in Taiwan.[207]

In China, multiple layers of shareholder protection mechanisms have been established, including corporate law, securities law, securities regulation, self-regulation and shareholder litigation, but protection of MSIs is apparently lacking.[208] Before the establishment of the MSI Center, there were already two other investor protection agencies: the China Securities Investor Protection Fund Corporation[209] (the Fund Corporation) and the Investor Protection Bureau within the CSRC[210]. But their roles are far from protecting the interests of MSIs. With no authority or responsibility to pro-actively take actions in protecting investors, the Fund Corporation acts as an insurance entity, which is to provide compensation to investors when brokers encounter emergency situations.[211] The Investor Protection Bureau, on the other hand, is just an internal department of the CSRC, with responsibility for formulating poli-

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[205] See the official website of this association: <https://www.australianshareholders.com.au>.

[206] See the official website of this association: <https://sias.org.sg>.

[207] The name in Chinese is *Zhèngquàn tóuzī rén yǔ qíhuò jiāoyì rén bǎohù zhōngxīn,* see its official website: <https://www.sfipc.org.tw>.

[208] See Y. MIAO, *Zhōngguó zhèngquàn fǎlǜ shíshī jīzhì yánjiū* [Research on the Enforcement mechanism for China's Securities Law], (Peking 2017) 81–91, 114–121, 147–149.

[209] The name in Chinese is *Guó zhèngquàn tóuzī zhě bǎohù jījīn yǒuxiàn zérèn gōngsī.*

[210] The name in Chinese is *Zhèngjiān huì tóuzī zhě bǎohù jú.*

[211] See the *Zhèngquàn tóuzī zhě bǎohù jījīn guǎnlǐ bànfǎ* [Administrative Regulation on Securities Investor Protection Fund], issued by the CSRC, effective as of 1 June 2016.

cy and rules to protect investors.[212] Again, it plays no role in taking actions to address problems of individual companies or shareholders.

To fill this gap, the MSI Center was established in December 2014, with approval from the CSRC and a registered capital of 3 billion Yuan, which was contributed in full by four investors who are all state entities: the two stock exchanges, the futures exchange and the trading registrar for exchanges.[213] From its inception, the MSI Center has held the privilege of being an entity directly authorized and supported by the state. To qualify as a shareholder of listed companies and to take various actions in such a capacity, the MSI Center has acquired 100 shares in all the companies listed on both stock exchanges in China and is holding these shares in the long term, pursuant to two sets of MSI internal rules and with the approval of the CSRC.[214]

The policy goals of the MSI Center are twofold. The first is to serve as a showcase for other shareholders, so as to raise awareness of the latter in taking actions to protect their own interests. Such a goal apparently is not the typical objective of shareholder activists. It also assumes that the current failure of shareholders to take action is due to the fact that they do not know how to do so, which seems not necessarily to be the case. The second policy objective of the MSI Center, interestingly, is more typical for a shareholder activist: to improve the compliance and performance of listed firms through participation in the corporate governance of listed firms.

To assess whether it is an active and effective shareholder activist, we have set out below more details as to how the MSI Center has exercised its rights and authority as a shareholder. The head of the MSI Center emphasized the five types of actions taken by the MSI Center, namely (1) submit a proposal in the capacity of a shareholder, (2) exercise the right to information, (3) exercise the right to inquiries, (4) conduct a media campaign and (5) carry out shareholder litigation.[215] Some of these roles are typically taken by shareholder activists but others are not, such as the participation of the MSI Center in shareholder litigation. Details of such participation are set out in Section 4 below.

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[212] Wuhan University Research Team, *supra* note 194, 393–436.

[213] See information on the official website of the MSI Center: <www.isc.com.cn>.

[214] See the *Chí gǔ xíng quán shìdiǎn gōngzuò fāng'àn* [Tentative Working Plan as Shareholder], MSI Center and following amendments, approved on 20 February 2016 and in April 2017 respectively.

[215] See the interview with the general manager of the MSI Center by the Xinhua News Agency, M. Xu: *Tóu fú zhōngxīn 'wǔdà juézhāo' bǎohù zhōngxiǎo tóuzī zhě de héfǎ quányì* ["five great tricks" of the investment center protect the rights and interests of small and medium investors], 17 July 2017, available at the official website of the Xinhua News Agency: <http://www.cs.com.cn/xwzx/201707/t20170717_5377345.html>.

1. Shareholder Proposals

According to the official data of the MSI Center, it made 351 shareholder proposals in 2017, all of which focus on the articles of association of listed firms.[26] In some of these proposals, the MSI Center urged listed firms to amend their articles to fully comply with certain rules and mandates issued by the State Council and the CSRC in protecting the interests of MSIs, such as online voting and elimination of minimal shareholding requirements for proxy access.[217] The MSI also made proposals calling for the elimination of certain anti-takeover measures adopted by listed firms in their articles, such as the reporting obligation of shareholders with 5% or more of shares (alone or together with parties acting in concert), an especially high threshold for special resolutions, and a staggered board.

Amazingly, all the firms receiving proposals from the MSI Center provided responses and over a hundred listed firms amended their articles accordingly.[218]

2. Exercising the Rights of Information

As indicated in the official data of the MSI Center, as of the end of 2017, it had exercised rights of information with respect to 41 listed firms located in 12

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[216] See information on the official website of the MSI Center, the Wechat account of the MSI Center and Z. KAI, *Tóu fú zhōngxīn jiànyì sì shàngshì gōngsī gǎizhèng "fǎn shōugòu" bùdāng tiáokuǎn* [The MSI Center suggested that Four Listed Companies amend their Anti-takeover Provisions in their Articles of Association], Zhèngquàn shíbào, 6 February 2017, available via the official website of the Securities Times China: <www.stcn.com/2017/0206/13036656.shtml>.

[217] See Art. 78 para. 2 of the Mandatory Articles of Association of Listed Firms: *Gǔdōng dàhuì shěnyì yǐngxiǎng zhōngxiǎo tóuzī zhě lìyì de zhòngdà shìxiàng shí, duì zhōngxiǎo tóuzī zhě biǎojué yīngdāng dāndú jì piào. Dāndú jì piào jiéguǒ yīngdāng jíshí gōngkāi pīlù* [When a general meeting of shareholders considers a major event affecting the interests of small and medium investors, voting for small and medium investors shall be counted separately. The results of separate counting shall be disclosed in a timely manner.]; State Affairs No. 110: *hào "guówùyuàn bàngōng tīng guānyú jìnyībù jiāqiáng zīběn shìchǎng zhōngxiǎo tóuzī zhě héfǎ quányì bǎohù gōngzuò de yìjiàn" zhōng guīdìng, shàngshì gōngsī gǔdōng dàhuì shěnyì yǐngxiǎng zhōngxiǎo tóuzī zhě lìyì de zhòngdà shìxiàng shí, duì zhōngxiǎo tóuzī zhě biǎojué yīngdāng dāndú jì piào* [Opinions of the General Office of the State Council on Further Strengthening the Protection of the Legal Rights and Interests of Small and Medium-sized Investors in the Capital Market stipulates that when a general meeting of listed companies considers major issues affecting the interests of small and medium investors, it votes on small and medium investors. Tickets should be counted separately.] (as of 2013).

[218] See the news report: *Tóu fú zhōngxīn: Wánchéng quánmiàn chí gǔ yīfǎ xíngshǐ gǔdōng quánlì* [The MSI Center: Completing the Acquisition of Shares and Get Ready to Exercise Shareholders Rights According to Law], People's Daily, 9 May 2017, available via the official website: <http://money.people.com.cn/stock/n1/2017/0509/c67815-29263412.html>.

provinces in China by requesting access to articles of association, resolutions of shareholders meetings, board meetings, supervisor meetings and relevant meeting minutes. Subsequently, the MSI Center identified certain issues – such as procedural non-compliance provisions, procedural defects in convening meetings and keeping meeting minutes, and failures of listed companies in satisfying information requests from shareholders – and requested corrections.[219]

3. Exercising the Right to Make Inquiries

One way that a shareholder activist imposes pressure on listed firms to change their behavior is by asking tough questions to firms and their managers. A typical occasion of this is the general meetings of shareholders. As of August 2017, the MSI Center had attended shareholders' meetings of 58 listed companies, raising inquiries 163 times.[220] Meanwhile, the MSI Center also gained the privilege of attending two other types of meetings and raising inquiries at those meetings: the special information sessions for investors (SISIs)[221] and the information sessions for major restructuring (ISMRs).[222] While the SISIs are open to any investors of a given listed firm, no regular

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[219] S. ZHOU, *Tóu fú zhōngxīn mìjí kāizhǎn xiànchǎng xíng quán yǐ fùgài shànghǎi, guǎngdōng, ānhuī, chóngqìng děng 12 gè xiáqū* [The MSI Center Exercised Shareholders Rights Frequently in 12 Jurisdictions including Shanghai, Guangdong, Anhui and Chongqing], Zhōng zhèng wǎng, 16 October 2017, available via: <http://www.cs.com.cn/xwzx/201710/t20171016_5515153.html>.

[220] B. ZHU, Tóu fú zhōngxīn 15 gè yuè chí gǔ xíng quán 618 cì "yītǐ liǎngyì" zhī jiù tóuzī zhě quányì bǎohù wǎng [The MSI Center Exercised Shareholders Rights 618 Times in the past 15 Months to protect Investors' Interests], Zhèngquàn rìbào, 15 September 2017, A1.

[221] In Chinese, it is *Tóuzī zhě shuōmíng huì* [investor briefing]. It is required under relevant rules issued by the stock exchanges in Shanghai and Shenzhen, such as Art. 8 Notice of the Shanghai Stock Exchange on Further Strengthening the Management of Investor Relations of Listed Companies: *Shàngshì gōngsī xiāngguān zhòngdà shìxiàng shòudào shìchǎng gāodù guānzhù huò zhíyí de, chú yīngdāng ànzhào shàngshì guīzé jíshí lǚ háng xìnxī pīlù yìwù wài, hái yīngdāng tōngguò xiànchǎng, wǎngluò huò qítā fāngshì zhàokāi shuōmíng huì, jièshào qíngkuàng, jiěshì yuányīn, bìng huídá xiāngguān wèntí. Shàngshì gōngsī dǒngshì zhǎng, zǒng jīnglǐ, dǒngshìhuì mìshū, cáiwù zǒngjiān huò qítā zérèn rén yīngdāng cānjiā shuōmíng huì* [If a major item related to a listed company is highly concerned or questioned by the market, in addition to timely fulfilling its information disclosure obligations in accordance with the Listing Rules, it shall also hold a briefing session on the spot, online or other means to introduce the situation, explain the reasons, and answer relevant questions. The chairman, general manager, secretary of the board of directors, chief financial officer or other responsible person of the listed company shall attend the briefing session], *Guānyú jìnyībù jiāqiáng shàngshì gōngsī tóuzī zhě guānxì guǎnlǐ gōngzuò de tōngzhī,* Shanghai Stock Exchange, CLI.6.177263/2012.

[222] In Chinese, it is *Zhòngdà zīchǎn chóngzǔ shuōmíng huì.*

MSIs bother to attend. The ISMRs, on the other hand, have not been open to investors but the MSI Center obtained a special privilege to attend them.

The SISIs are mandatory when an event relating to a listed firm has drawn a high level of attention or suspicion in the market. A listed firm could host the SISIs live, online or in other forms to provide information to the market, in addition to the mandatory disclosure requirements. The chairman of the board, the general manager, the secretary of the board, the chief financial officer and other relevant managers are required to attend the SISIs. The MSI Center raised questions regarding compliance, such as investor limitations set out in the articles and compliance issues in distributions. The MSI Center also challenged the business judgment of executives in cases of major asset acquisitions. This included questioning the commercial viability and profit forecast of the target assets.

Unlike the SISIs, the ISMR is required before a listed firm resumes the trading of its stocks relating to major restructuring. Controlling shareholders, the entities with *de facto* control, the board of directors, the management, and the restructuring parties are to attend the ISMR to address inquires.[223] Originally, only a list of media designated by the CSRC was permitted to attend the ISMR, but starting from 1 July 2016, representatives of the MSI Center have been invited to attend the ISMRs and to raise questions, together with securities analysts and journalists.[224]

As of the end of 2017, the MSI Center had attended ISMRs 30 times and raised inquiries regarding various issues, mainly focusing on the uncertainties of restructuring and on how relevant listed firms plan to address these uncertainties. For example, the MSI asked about potential risks that may affect the closing of the proposed restructuring and whether the listed firms have any plans to address such risks. The MSI Center also queried the particulars of the target assets in a few proposed restructurings, such as profitability, ownership status, evaluation and provisions for future losses. In justifying the proposed restructuring, listed firms often make covenants regarding future performance. The MSI Center challenged the reasonableness and feasibility of such covenants and whether the relevant listed firms have plans to provide compensation in the event of failure to meet these covenants, especially compensation to protect the interests of MSIs. The MSI Center challenged a number of listed firms as to their disclosure of related transactions.[225]

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[223] *Guānyú yángé chóngzǔ shàngshì jiānguǎn gōngzuò de tōngzhī* [The CSRC Circular on Tightening Regulation of Mergers and Acquisition by Listed Company], CSRC, 30 June 2016.

[224] See Art. 9 *Shàngshì gōngsī chóngzǔ shàngshì méitǐ shuōmíng huì zhǐyǐn* [Guidelines on the Media Conference for Mergers and Acquisitions by Listed], Shanghai Stock Exchange, 1 July 2016.

[225] Based upon telephone interviews conducted by *Nan Wang* with the MSI Center, dated 22 December 2017.

So far, at least three firms have suspended their restructuring plans and twelve firms have amended their original plans according to the media report.[226] It is almost impossible to prove the causation between such a result and the efforts of the MSI Center in raising inquiries, but such an effort may have had a real impact on the behavior of listed firms and their managers.

4. Media Campaign

A media campaign is a typical action taken by shareholder activists to press listed firms for change. During the two years of 2016 and 2017, the MSI Center conducted 12 media campaigns regarding some of the most controversial transaction of listed firms, such as the hostile takeover of Wanke by Baoneng.[227] On other occasions, the MSI Center urged a controlling shareholder to perform its non-compete covenants towards the relevant listed firm and threatened litigation if the controlling shareholder failed to do so.[228] In a takeover transaction, the MSI Center raised doubts as to a few critical aspects of the transaction, such as whether the management acquired control of the target and whether a private equity investor rushed to invest in the listed firm in order to channel interests to the relevant entity, whether the target business had the potential to be profitable in the future, and whether the shareholders' resolutions were in full compliance with substantive and procedural requirements.[229]

In addition to targeting particular firms, the MSI Center also made some general announcements in public to draw the attention of the stock exchanges and the CSRC to certain provisions prevailing in articles of association of a few listed firms and threatened to sue those firms if they failed to correct

[226] See S. ZHOU, *Duō guǎn qí xià gòuzhù quán fāngwèi tóuzī zhě bǎohù tǐxì* [Multiple Methods to Build a Comprehensive System of Protection for Investors], Zhōng zhèng wǎng, 29 December 2017, available via: <http://www.cs.com.cn/zt/2017ye/sc/03/201712/t20171229_5646142_1.html>.

[227] Xinhua News Agency, *Tóu fú zhōngxīn:"Wànbǎo zhī zhēng", zhōngxiǎo tóuzī zhě héfǎ quányì bìxū dédào wéihù* [The MSI Center: In the Dispute between Wanke & Baoneng, The Interests of the Public Investors Must Be Protected], Xinhua News Agency, 2 July 2016, available via: <http://www.xinhuanet.com/finance/2016-07/02/c_129109832.htm>.

[228] B. ZHU, *Tóu fú zhōngxīn qiǎnzé yǎ bǎi tè nǐ yú 26 rì cānjiā gǔdōng dàhuì* [The MSI Center Criticised Ya Bai Te in Public and Will Attend Its Shareholders Meeting on the 26th], Zhèngquàn rìbào.

[229] S. ZHOU, *Tóu fú zhōngxīn gōngkāi fāshēng wǔ wèn gélì diànqì* [The MSI Made a Public Announcement and Questioned Ge Li Appliance Five Times], Zhōng zhèng wǎng, 6 November 2016, available via: <http://www.cs.com.cn/sylm/jsbd/201611/t20161106_5088192.html>.

their articles in time.[230] As a follow-up in some cases, the MSI Center launched lawsuits against listed firms, particularly trying to invalidate shareholder resolutions which approved amendments to articles or certain transactions that the MSI Center found problematic.

III. Multiple Roles of the MSI Center in Shareholder Litigation

For a typical shareholder activist, launching shareholder litigation is not a conventional strategy. However, the MSI Center not only acted as plaintiff, but also played multiple roles regarding shareholder resolutions, such as initiator, administrator, funding entity and even mediator. When viewed together, these multiple roles played by the MSI Center highlight how different the MSI Center is from a conventional shareholder activist.

1. The MSI Center as Plaintiff in Shareholder Litigation

When the target of shareholder litigation is a resolution already passed at a shareholders meeting, the regular strategy for a conventional shareholder activist is to launch a proxy fight and to pass a new shareholder resolution to replace the existing one. In China, however, due to the difficulty of proxy access and a proxy fight as explained above, a special type of shareholder lawsuit was created as a substitute: shareholder litigation to invalidate shareholder resolutions.

The MSI Center has been reported to have launched such a lawsuit on 26 June 2017.[231] In this particular lawsuit, the MSI Center challenged a resolution which imposed a 3% and 90-day minimal shareholding requirement on shareholders' right to propose candidates for the board of directors. Interestingly, before the court reached a conclusion on this suit, the listed firm had its articles of association amended and such limits were deleted from the articles. What seems to have mattered is not the result of the litigation, but the pressure exerted on the listed firms by the litigation.

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[230] Xinhua News Agency, *Tóu fú zhōngxīn shǒu lì gǔdōng sùsòng shèngsù* [The MSI Won Its First Shareholder Lawsuit], Xinhua News Agency, 11 May 2018, available via: <http://www.xinhuanet.com/legal/2018-05/11/c_1122819787.htm>.

[231] See People's Court of Fengxian District, Shanghai, Judgement No. (2017) Hu 0120 Minchu 13112. Also see media report as follows: <http://www.cs.com.cn/xwzx/2017 06/t20170630_5349764.html>. For the specific reasons given by the MSI Center, it is based upon telephone interviews conducted by *Nan Wang* with the MSI Center, dated 22 December 2017.

2. Supporting Securities Fraud Litigation

For a long time, shareholders in China simply could not use securities litigation as a method to seek remedy or to deter future fraud. Following the amendment to the Securities Law of China in 2005, civil litigation became a formal legal tool available to shareholders of listed firms,[232] following about three years of sporadic judicial practice by the Supreme Court.[233] However, shareholders' rights to sue about securities fraud are subject to one critical condition over which they have had no control at all ever since 2003: they can only do so after the stock market regulator, later the CSRC, has already imposed an administrative sanction or a criminal sanction over such securities fraud. It is hence no surprise that such litigation has been sporadic.

Even with respect to the securities fraud already sanctioned by regulators, shareholders also did not seem eager to sue. For example, research suggested that in the period between 2002 and 2011, with respect to all securities fraud cases where administrative or criminal sanctions had been imposed, only 25.7% were followed by civil litigation.[234] Such a pre-condition was finally eliminated at the end of 2015,[235] but investors' participation rate in such shareholder litigation remains extremely low: on average, only about 0.22% of shareholders of the given listed firms participated in the securities litigation in the top 13 cases, as measured by the amount of compensation awarded by court, between 2013 and 2016.[236] The reasons for such a low rate of participation are complicated, but it is safe to claim that shareholders in China have very little incentive to turn to litigation for protection or deterrence.

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[232] B. L. LIEBMAN/C. J. MILHAUPT, Reputational Sanctions in China's Securities Market, Columbia Law Review 108 (2008) 929.

[233] *Zuìgāo rénmín fǎyuàn guānyú shòulǐ zhèngquàn shìchǎng yīn xūjiǎ chénshù yǐnfā de mínshì qīnquán jiūfēn ànjiàn yǒuguān wèntí de tōngzhī* [The Supreme Court Circular on The Issues Regarding Admission of Civil Torts Cases Arising out of Securities Fraudulent Statements], 15 January 2002. Also see *Zuìgāo rénmín fǎyuàn guānyú shěnlǐ zhèngquàn shìchǎng yīn xūjiǎ chénshù yǐnfā de mínshì péicháng ànjiàn de ruògān guīdìng* [Supreme Court Circular on the Issues Regarding Civil Liability of Compensation Arising out of Securities Fraudulent Statements], effective as of 1 February 2003.

[234] H. HUI, *Zhōngguó zhèngquàn xūjiǎ chénshù mínshì péicháng zhìdù: Shízhèng fēnxī yǔ zhèngcè jiànyì* [China's Civil Liability Compensation for Securities Fraudulent Statement Cases: Empirical Study and Policy Suggestion], Zhèngquàn fǎ yuàn 9 (2013) 974.

[235] See *Guānyú dāngqián shāngshì shěnpàn gōngzuò zhōng de ruògān jùtǐ wèntí* [Supreme Court Circular on The Issues Regarding Current Commercial Cases Adjudication], 24 December 2015.

[236] W. XU, *Zhèngquàn mínshì sùsòng yǔ tóuzī zhě péicháng - jīyú xūjiǎ chénshù ànjiàn de shízhèng fēnxī* [Securities Fraud Litigation and Investor Compensation: An Empirical Study of Securities Fraudulent Cases], Shandong University Journal (Philosophy & Social Science) (2017) 69.

In response, the MSI Center launched a pioneering program to "support securities fraud litigation"[237] under a general authorization under Art. 15 Civil Procedure Law: Any government authority, social organization or enterprise may support enterprise or natural person victims in launching lawsuits in court, with respect to actions that infringed the civil rights and interests of the state, the collectives and individuals. Curiously, the relevant laws and judiciary rules failed to specify the term "support," which, however, created fertile ground for the MSI Center to explore.

As of 11 March 2018, the MSI Center had launched seven such cases, all of which had previously been sanctioned by the CSRC. Among these cases, two have been completed, two are pending court judgment and the other three are still in the process of open solicitation of qualified plaintiffs, according to information on the official website of the MSI Center. One of the two completed cases proved to be a huge success[238] and was selected by the Supreme Court of China as one of the top 10 showcases for civil-administrative cases in 2017.

In those cases, the "support" that the MSI Center provided makes it look very much like the "lawyer entrepreneur" in securities class actions in the United States.[239] But the MSI Center itself does not always act as a professional attorney. Instead, it has provided administrative coordination and initial work of professionals for potential plaintiffs in securities litigation. In those cases, it simply engaged and paid lawyers to provide services to the qualified plaintiffs that they identified. The MSI Center has executed a memorandum with the China Lawyers' Association to seek public-interest lawyers to provide services in such cases, to be paid by the Center.[240]

3. *The MSI Center as Mediator*

Last but not least, since July 2016 the MSI Center has worn the hat of mediator for disputes between securities investors and listed firms as well as those between investors and financial intermediaries such as brokers, fund managers, investment consultants, auditors and lawyers.[241] In 2017, the MSI Center medi-

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[237] In Chinese, the term is *Zhèngquàn zhīchí sùsòng,* for more details, see the explanation provided on the official website of the MSI Center: <http://www.isc.com.cn/rights/201705/t20170517_171525.shtml>.

[238] See the Supreme People's Court, 2016, Judgement No. (2016) Shanghai 01 Minchu No. 166.

[239] J. COFFEE JR., Understanding the Plaintiff's Attorney: The Implications of the Economic Theory of the Private Enforcement of Law through Class and Derivative Actions, Columbia Law Review 86 (1986) 669.

[240] See announcement dated 1 July 2016 on *Shànghǎi zhèngquàn bào* [Shanghai Securities Daily]. The details of such cooperation, such as fee arrangements, were based upon telephone interviews conducted by *Nan Wang* with the MSI Center, dated 23 January 2018.

[241] *Guānyú zài quánguó bùfèn dìqū kāizhǎn zhèngquàn qíhuò jiūfēn duōyuán huàjiě jīzhì shìdiǎn gōngzuò de tōngzhī* [The Joint Circular On Trial Work on Using Alternative

ated 2505 cases and closed 1907 cases, of which the parties reached settlements in 1661 cases and the settlement amount totaled more than 0.35 billion Yuan (over 5 million US-Dollar).[242] In a few designated courts, litigants may switch to the MSI Center for mediation after they file lawsuits in those courts, and such a service is free of charge for the parties. If a settlement is reached under such mediation, the parties may apply to the court to confirm such a settlement agreement to turn it into an enforceable judicial document.

Disputes between investors and listed firms are one type of dispute mediated by the MSI Center. For the period between September 2014 and May 2017, under the authorization of a court in Shanghai, the MSI Center completed the mediation of 496 such disputes, and parties reached settlements in 134 cases.[243]

The absolute value of settlements in those cases seems very trivial. But it is revolutionary that an entity with a role such as shareholder activist also provides dispute resolution that is enforceable in court.

IV. Advantages and Challenges as a Shareholder Activist

The term "activist" or "activism" has never appeared in the official description of the MSI Center. But this center is clearly operating in ways very similar to a shareholder activist. In fact, its rather unique institutional set-up and its funding source are seemingly helpful in securing the independent position and expertise of the MSI Center; both are essential for an effective shareholder activist. More importantly, it did not derive such advantages and privileges from any market power or market influence over the listed firms and their controlling parties. Instead, its advantages all come from the authorization of the state, which is the ultimate regulator responsible for the integrity of the market and the protection of the MSIs that have empowered the MSI Center. It is the same case for its incentives in taking actions to chase firms and their controlling parties.

To be sure, such a natural extension of regulatory power is not only understandable and creative, but even necessary, given that MSI investors have

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Dispute Resolution for Securities and Futures Investment Disputes in Certain Regions in China], China's Supreme Court and the CSRC, 25 May 2016.

242 See the MSI Center's 2017 Annual Report on Dispute Resolution, *Tóu fú zhōngxīn 2017 niándù tiáojiě gōngzuò zǒngjié* [Summary of 2017 mediation work in the service center], MSI Center, 8 January 2018, available via its official WeChat Account: <https://mp.weixin.qq.com/s/kfXeb_qkLRvaavH1zl1W3g>.

243 J. YAN/H. LIU, *Shànghǎi yī zhōng yuàn shāngshì jiūfēn de "fēi líng hé" jiějué fāng'àn* [Shanghai First Intermediary Court: The Non-Zero-Sum Game], Fǎ zhōukān, 24 July 2017, available via the official website of the Chinese court: <http://rmfyb.chinacourt.org/paper/images/2017-07/24/05/2017072405_pdf>.

very few alternative methods to protect their interests and to deter the behavior of the listed firms in China, such as judiciary remedies and regulatory sanctions. This said, we should not forget the fact that all government entities have the tendency of expanding their jurisdiction and power.[244] Such a tendency may also apply to the MSI Center, which can be viewed as a quasi-governmental entity. In addition, its status as a government-invested entity affiliated with regulators, providing free services for dispute resolution, has already created clear conflicts of interest, threatening its independence and effectiveness in protecting the interests of the MSIs.

1. *Information, Expertise & Incentives*

One thing that distinguishes a shareholder activist from a regular minority shareholder is the ability to process information and the possession of expertise. In addition, the MSI has also acquired additional access to information that is otherwise not available to a regular shareholder. Moreover, it has obtained such information and expertise with secured financial support from the government and at no additional cost. Such cost advantages clearly distinguish the MSI Center from a regular shareholder activist.

At the same time, the MSI Center has been leveraging the above advantages in two ways. One is to provide the support of free legal services to qualified public investors in their litigation against listed firms and their controlling parties. It has hence created great opportunities for the consolidation of both financial resources and expertise from both the private and public sectors and increased the chances for shareholders to win these cases, hence providing remedies as well as deterrence. A second form of leverage by the MSI Center is increasing the media pressure on the defendants through its involvement in investigation and litigation, which is clearly illustrated above.

The special affiliation of the MSI Center with the government also resolved the serious issue of lack of incentives, from which many institutional investors and hedge funds suffer, even when they enjoy an apparent information advantage and expertise. One of the concerns for shareholder activists engaging the management of listed firms has been potential conflicts of interest: shareholder activists may well seek private payoffs at the costs of the interests of the company or those of public investors, either economic or non-economic. A study of the MSI protection agency in Taiwan seemed to have indicated the danger of such entities getting involved in the internal fights of listed firms and being captured by interest groups within the firms.[245] Since

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[244] K. M. Murphy/A. Shleifer/R. W. Vishny, Why Is Rent-Seeking So Costly to Growth?, The American Economic Review Papers and Proceedings 83 No. 2, (1993) 409.

[245] See C.-P. Shao, Representative Litigations in Corporate and Securities Laws by Government – Sanctioned Nonprofit Organizations: Lessons from Taiwan, Asian-Pacific Law and Policy Journal 15 (2014) 81.

the policy goal of the MSI Center is to deter irregular behavior by listed firms and their controlling parties, hence to protect the interests of minority shareholders, the MSI Center has perfect incentives to take every action that could possibly achieve such a goal, and thus to help it gain political credibility and legitimacy.

2. The Tendency of Self-growing and Conflict of Interest

This said, we need to be aware that the same incentives deriving from the policy goals of the MSI Center have a side effect: precisely because the MSI Center has this designated goal, without having to worry about the actual financial return of its investment, it is more like a government department that may pursue the growth of its own power and jurisdiction. Hence it is different from a conventional shareholder activist. One case in point is the fact that the MSI Center has not engaged in any proxy access or proxy solicitation, which are otherwise popular for regular shareholder activists.

To be sure, China's Corporation Law does provide for the possibility of proxy access and proxy solicitation for the exercise of certain collective rights of shareholders, such as the right to convene a special shareholder meeting and shareholder representative suits. It is also one of the tools listed in the charter of the MSI Center. Instead, it took the role of "entrepreneur lawyer" by soliciting qualified plaintiffs for securities litigation and even provided funding as well as free legal advice to qualified plaintiffs. One possible explanation for such a choice by the MSI Center is that proxy-related actions are not compatible with the goal of self-growth and self-expansion, in addition to the fact that the threshold set out under the current Corporation Law might be somewhat too stringent.

Compared with imposing pressure through media and acting like a securities litigation lawyer, proxy related-actions have two features: low visibility and high uncertainty.

By definition, the MSI Center would go out and present itself in the public when trying to put pressure or to invite qualified shareholders to initiate securities litigation. Such a public presence is critical and effective for a government entity, which by nature stands in front of the public. However, to get proxy access and engage in a proxy fight, the MSI would need to deal with shareholders instead of the general public, and hence be more private. Considering the cost of identifying individual public shareholders, reaching them and obtaining signed documents for granting the proxy, making a public announcement and notification is much less expensive and less cumbersome.

The associated high costs of proxy solicitation lead to yet another issue: uncertainty in obtaining proxy access. Given the large number of shareholders to reach and to obtain consent from, it is likely for the MSI Center to fail in the middle of this exercise, which would be wasteful and would harm the reputation of the MSI Center, especially as a state-funded and state-affiliated entity. In addition, even if the solicitation of the proxy is successful and the MSI Center can convene a special shareholders meeting, the MSI Center still has to face the uncertainty of forcing changes in the listed firms, such as board members and constitutional documents of the listed firms, because of the concentration of shareholding in most companies. The ultimate defeat of proposals by the MSI Center again may be regarded as wasteful and ineffective in the eyes and evaluation system of the public. Such a negative reputation can easily create an impediment for the MSI Center to maintain, let alone enlarge, its budget, staff size and scope of authority.

V. Conclusion

The dominance of the state in investment in China has generated rather weak shareholder activists in the conventional sense. However, the same state dominance in the stock market has given birth to a special type of *de facto* shareholder activist, the MSI Center. The dual role of the MSI Center as a shareholder activist and an extension of the securities market regulator give it superb and effective advantages over conventional shareholder activists. Moreover, it has increasingly tried to claim its separation from the CSRC and disclaims any potential authority as a speaker for the CSRC or regulator of the market or industry-based self-regulation, according to its working plans published in the media.[246] At the same time, its status as a quasi-governmental entity renders it vulnerable to a tendency toward self-expansion, about which certain measures should be put into place. Such a unique institution gives rise to interesting and challenging theoretical questions and hence opens new channels for evaluating shareholder activism. The MSI Center is surely the comprehensive state-control system in China's stock market which deserves particular research attention in the future.

[246] See *Chí gǔ xíng quán shìdiǎn gōngzuò fāng'àn* [Tentative Working Plan as Shareholder], MSI Center, Zhèngquàn rìbào, 20 February 2016, A02. Also see *Kuòdà chí gǔ xíng quán shìdiǎn fāng'àn* [Extended Tentative Working Plan as Shareholder], MSI Center, Zhèngquàn rìbào, 18 April 2017, B03.

Shareholder Activism in Korea

The Cases of PSPD and NPS

Kyung-Hoon Chun

I. Overview

Shareholder activism can be defined as "[…] the way in which shareholders can assert their power as owners of the company to influence its behavior," as stated on the website of the European Corporate Governance Institute,[1] or even more briefly as "[…] efforts by shareholders to exact change at targeted firms."[2] Given such a broad definition, a focused approach is necessary for a meaningful analysis of this phenomenon. In order to analyze the dynamics of shareholder activism in Korea, this chapter attempts to examine it through three lenses: *who, why,* and *how.*

Through the lens of *who,* we pay attention to the characteristics of the various players of shareholder activism such as hedge funds, institutional investors, and non-governmental organizations, revealing striking differences in

[1] <http://www.ecgi.org/activism/>.

[2] F. Partnoy, US Hedge Fund Activism, in: Hill/Thomas (ed.), Research Handbook on Shareholder Power (Cheltenham 2015) 101.

their activities. This *who* element has a close relation to the *why* element, which represents the motives behind shareholder activism. Sometimes activists are motivated by short-term economic gains, while at other times they are motivated (or at least say they are motivated) by other values such as long-term enterprise value, sustainable growth of the enterprise, or corporate social responsibility. Through the lens of *how,* we review the various legal tools used by shareholder activists. Actively participating in general meetings of shareholders (GMS), making shareholder proposals, engaging in hostile acquisitions, launching proxy solicitations, and bringing derivative suits are the traditional weapons of activists. Recently, ongoing discussions or "engagement" with management have been gaining in popularity.

Looking at shareholder activism through these lenses reveals that shareholder activism is far from monolithic. It may take different forms and have different implications depending on the main players involved, their motivations, and the types of legal tools utilized.

Based on such an understanding, this chapter aims to review and analyze shareholder activism in Korea over the past two decades by focusing on two players and their respective *why* and *how* elements. As background, Section II provides general information on the Korean capital market and shareholder powers under Korean law, especially under the Korean Commercial Code (KCC), the main statute governing for-profit corporations. Section III reviews shareholder activism in the late 1990s and early 2000s by People's Solidarity for Participatory Democracy (PSPD), a non-governmental organization. Section IV reviews a few episodes in the early 2010s, when the National Pension Service (NPS) was involved as an influential shareholder. And finally, Section V contains closing remarks.

II. Shareholder Power in Korea

1. Korean Capital Market

The Korea Exchange (KRX), the sole securities exchange operator in Korea, operates the Korea Composite Stock Price Index (KOSPI) market and the Korea Securities Dealers Association Automated Quotations (KOSDAQ) market. The KOSPI is perceived as a market for established firms, while the KOSDAQ, which was modeled and named after the National Association of Securities Dealers Automated Quotations (NASDAQ), is generally perceived as a market for smaller start-up companies. The market capitalization and number of listed companies on the KOSPI and the KOSDAQ markets as of the end of 2017 are shown in *Table 1.*

Table 1: Size of Stock Exchanges in South Korea (End of 2017)

	Number of Listed Companies	Market Capitalization (billion Won)
KOSPI	774	1,605,821
KOSDAQ	1,267	282,740
Total	2,041	1,888,561

Source: Website of Korea Exchange (<www.krx.co.kr>) (1,000 Won = approximately 0.9 US-Dollar)

The presence of foreign investors is an important factor in analyzing shareholder activism. Foreign investment in Korean listed firms increased dramatically during the Asian financial crisis in the late 1990s. Recently, however, the foreign shareholder ratio in the Korean stock market has been at a standstill. In terms of market value, foreign shareholders have held 31.2% (2010), 30.6% (2011), 32.5% (2012), 33.0% (2013), 31.6% (2014), 29.1% (2015), 31.8% (2016), and 33.6% (2017) of the total market capital of the Korean stock market.[3]

2. *Shareholder Rights under Korean Law*[4]

a) *Right to Vote*

Every Korean corporation, or *chusik hoesa,* must hold a GMS once a year pursuant to a resolution of the board of directors (Art. 365 para. 1 KCC). This is called an ordinary or annual GMS. In addition, the board may call a GMS at any time whenever necessary, which is usually called an extraordinary GMS (Art. 365 para. 3 KCC).

At a GMS, holders of voting stock are entitled to vote. It is noteworthy that Korean law maintains a strict "one share, one vote" rule (Art. 369 para. 1 KCC). The creation of shares with multiple or fractional votes is not allowed, even if there are such provisions in the articles of incorporation.

In order to pass a resolution at a GMS, either the ordinary or special resolution requirements must be satisfied, depending on the agenda item. Unless otherwise provided for in the KCC or articles of incorporation, a resolution at a GMS requires a majority of the votes present at the meeting, which must also be at least one fourth of the total number of voting shares (Art. 368 para. 1 KCC). This is called an ordinary resolution and applies to, among other things, elections of directors and statutory auditors, approvals of financial statements, declarations of dividends, and stock repurchases. For certain mat-

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3 <http://www.index.go.kr/potal/main/EachDtlPageDetail.do?idx_cd=1086> (in Korean).

4 For more details, see K. CHUN/K. KIM/H. RHO/O. SONG, Corporation and Partnerships in South Korea (2nd ed., Alphen aan den Rijn 2015).

ters, an ordinary resolution does not suffice and a special resolution is required. A special resolution is passed by at least two thirds of the votes present at the meeting, which must also be at least one third of the total number of voting shares (Art. 434 para. 1 KCC). Agenda items that require a special resolution include removal of directors, granting of stock options, reductions of legal capital, mergers, spin-offs, business transfers, dissolution, and amendments of the articles of incorporation.

A shareholder may cast votes either personally or by proxy (Art. 368 para. 2 KCC). For listed firms, those who wish to solicit proxies must (i) file a report with the regulator and (ii) make public disclosures regarding the soliciting party and the target company. Shareholders are allowed to vote in writing if authorized by the articles of incorporation (Art. 368-3 KCC). Electronic voting is allowed if authorized by the board of directors (Art. 368-4 KCC).

b) Election and Removal of Directors

Directors are elected at an ordinary or extraordinary GMS. Usually, director candidates nominated by the current board of directors[5] are indicated as such in the GMS notices, and shareholders cast votes for or against each candidate. If the number of affirmative votes satisfies the ordinary resolution requirements (i.e., a majority of votes present at the meeting and at least a quarter of total issued voting shares), then the candidate is elected as a director. This may be referred to as "majority rule" as opposed to "plurality rule" in the sense that the candidate must acquire affirmative votes from the majority of the shares present at the meeting. Under this scheme, majority shareholders have, in effect, absolute power to appoint all board members.

In order to curtail majority shareholders' power and protect minority shareholders, the KCC has adopted a cumulative voting system. When two or more directors are to be elected at a GMS, shareholders having at least 3% (1% in case of large listed firms) of the shares may request that the resolution be passed by cumulative voting (Art. 382-2 para. 1 KCC). However, the company may opt out of cumulative voting in its articles of incorporation (Art. 382-2 para. 1 KCC). More than 90% of the listed firms in Korea have opted out of cumulative voting through their articles of incorporation. Thus, those who argue for corporate governance reforms in Korea often propose that the KCC be amended to make cumulative voting mandatory for listed companies over a certain size.

It is noteworthy that shareholders may remove directors by a special resolution of a GMS *without* cause at any time (Art. 385 para. 1 KCC). If the director is removed during his term of office without just cause, that removed

[5] Outside directors of large listed companies and financial institutions are nominated by the Outside Director Candidate Nomination Committee, which is a subcommittee of the board of directors.

director is only entitled to monetary compensation from the company (Art. 385 para. 1 KCC), which generally corresponds to the remuneration he could have earned during the remainder of the term of office had he not been removed. Such potential for unilateral removal shows the great power given to shareholders under Korean law.

c) Rights to initiate Corporate Decision making

Even though shareholders' voting power is important in corporate governance, it can only be exercised when a GMS is convened, and only with respect to the agenda items presented at the GMS. Incumbent directors determine whether to convene a GMS and set the date, location, and agenda items for the GMS. In other words, shareholders exercise their voting power within the framework set by the board. The KCC provides two powerful weapons as exceptions to this passive aspect of shareholder power: the right to call an extraordinary GMS and the right to make a proposal for the GMS.

Shareholders holding at least 3% of the total issued shares may request that the board call an extraordinary GMS (Art. 366 para. 1 KCC). For a listed firm, the shareholding threshold is lowered to 1%, although a six-month holding period is required (Art. 542-6 para. 1 KCC). The shareholders must submit to the board a written statement regarding the agenda and reasons for the GMS. If the board fails to take immediate steps to convene a GMS, the shareholders may convene a GMS by themselves with the approval of the court (Art. 366 para. 2 KCC).

Shareholders holding 3% of the total issued shares are entitled to submit a proposal to be resolved at the GMS (Art. 363-2 paras. 1, 2 KCC). For a listed firm, the shareholding threshold is lowered to 1% (0.5% in the case of a larger firm), although a six-month holding period is required (Art. 542-6 para. 2 KCC). The board of directors must include the proposed item in the agenda except in certain cases, such as when the substance of the proposal is in violation of the law or the articles of incorporation (Art. 363-2 para. 3 KCC). The removal of a director can be also initiated by shareholder proposal, but the board of directors of listed companies may legitimately refuse to include it in the GMS agenda. For unlisted companies, the board must include the removal of a director in the GMS agenda if it was duly proposed by shareholders. Amendment of the articles of incorporation is a legitimate item for proposal, so the board of directors must include it in the GMS agenda if it was duly proposed by shareholders.

d) Right to Pursue Director Liability

Under the KCC, shareholders holding at least 1% (0.01% for at least 6 months for listed firms) of the total issued shares have a right to bring a derivative action on behalf of the company. Before filing a derivative action, the shareholder must demand that the company bring a suit against the relevant director (Art. 403 para. 1 KCC). If the company fails to bring a suit within thirty days of the date of demand, the shareholder may immediately bring a derivative action on behalf of the company. If any irreparable damage is likely to arise, the shareholder may bring a derivative action immediately without making such a demand beforehand (Art. 403 para. 3 KCC).

A derivative remedy is available only after the company suffers damage from a director's misconduct. Before such misconduct, the KCC allows for injunctive remedies. When a director is likely to commit a breach of the law or the articles of incorporation and the company may incur irreparable damage as a result of the breach, a 1% (0.05% or 0.025% depending on the size of the company for at least six months for listed firms) shareholder, as well as a statutory auditor, may seek injunctive relief prohibiting the relevant director from undertaking the act in question (Art. 402 KCC).

In order to facilitate derivative actions or injunctive relief, the KCC allows shareholders the right to access corporate records. Each shareholder may inspect or copy the financial statements and audit reports kept at the company's main or branch office (Art. 448 para. 2 KCC). In addition, shareholders with 3% (0.1% or 0.05% depending on the size of the company for at least six months for listed firms) or more of the total shares may gain access to the accounting books and records (Art. 466 para. 1 KCC). Directors must prove the unreasonableness of a shareholder demand in order to refuse it (Art. 466 para. 2 KCC).

e) *Preemptive Rights*

The KCC grants preemptive rights to existing shareholders in order to protect them from the likely dilution of share value. Unless otherwise provided for in the articles of incorporation, each shareholder has a right to subscribe to new shares in proportion to his or her shareholding (Art. 418 para. 1 KCC). As an exception to this rule, the issuance of new shares to a third party is possible if the company has underlying provisions in its articles of incorporation and a proper business purpose for such a third-party allotment (Art. 418 para. 2 KCC). Most listed companies have some provisions in their articles of incorporation restricting the preemptive rights of existing shareholders, but the court does not easily recognize "a proper business purpose" when new shares are issued to defend against hostile takeovers. The Supreme Court of Korea held that defending against hostile takeovers did not constitute a proper business purpose for issuing new shares to a third party.[6]

[6] Korean Supreme Court, 30 January 2009, 2008Da50776.

3. Remarks

As shown above, at least as a matter of black letter law, shareholders have quite a strong set of rights under Korean law. For example, shareholders with a certain threshold amount of shares may call an extraordinary GMS, initiate an amendment to the articles of incorporation by way of shareholder proposal, remove directors without cause at any time through a special resolution, and even enjoy the preemptive right to subscribe to new shares on a pro rata basis. These are the representative characteristics of the UK model of strong shareholders, as opposed to the US model of weak shareholders.[7] At least in these respects, Korean law resembles UK law rather than US law.

In reality, however, there are significant hurdles to exercising these rights. First, the shareholding thresholds for exercising certain rights are restrictive and sometimes prohibitively high. For example, bringing a derivative action requires holding 1% of the issued shares for unlisted firms and 0.01% of the issued shares for listed firms. For large listed firms, 0.01% may represent millions of US dollars in terms of stock price, which makes the derivative action virtually unavailable for most minority shareholders. Second, the Korean judicial system and its practices are generally not friendly to plaintiffs. Korean law does not have any US-style discovery system whatsoever and does not allow class actions except for certain securities litigation.[8] Since punitive damages are not recognized, the amount of monetary compensation is limited to the actual damage suffered by the plaintiff, and the burden of proof generally lies with the plaintiff. Thus, civil actions and the possibility of civil liability in general pose less of a threat than criminal charges or administrative penalties in Korea.

Although there are practical hurdles, it is true that Korean law provides a variety of legal tools to shareholders. Shareholders in many other jurisdictions – including many states in the US – lack the ability to convene an extraordinary GMS or to propose an amendment to the articles of incorporation. The cases of PSPD and NPS as discussed below show how these legal rights have been invoked and utilized for shareholder activism.

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[7] C. BRUNER, Corporate Governance in the Common-Law World – The Political Foundations of Shareholder Power (Cambridge 2013) 37–40. In addition to these four rights (whether shareholders may call a special meeting, remove directors without cause, initiate charter amendments, and have preemptive rights), Professor Bruner also reviews whether shareholders may ‘approve takeover defenses’ and ‘compel board action’. For all six of these rights, UK law is positive while Delaware law is negative.

[8] Securities Related Class Action Act (enacted in 2003 and effective as of 2005).

III. NGO's Activism: the Case of PSPD

1. PSPD

People's Solidarity for Participatory Democracy (PSPD) was founded in 1994 in Seoul by certain "[…] activists, scholars and lawyers who were engaged in various democratic movements for participatory democracy and human rights."[9] PSPD's own website explains its purpose as "[…] promoting people's participation in government decision making processes and socio-economic reforms, by closely monitoring the abuse of power of the state and corporations to enhance transparency and accountability."[10] In the late 1990s when PSPD's shareholder activism was at its peak, PSPD was made up of several sections, each of which specialized in a specific legal movement such as anti-corruption, social welfare, the labor movement, the taxpayer movement, and consumer protection. One of the sections was the Economy Democratization Committee (EDC), which launched a minority shareholder campaign in early 1997.

In order to understand PSPD's motives behind its activism, we need to take a brief look at the movement regarding "public interest law" in Korea that set the backdrop for its activities. Throughout the 1980s, many civil and student activists struggled for democracy against the authoritative government. In June 1987, a nationwide democratic movement known as the June Democratic Uprising, which included mass protests on the streets of major Korean cities, forced the government to accept a direct presidential election and an amendment to the Constitution to better protect basic human rights. In line with such a movement, what was known as a "public interest law movement" was started by a group of lawyers and professional elites. A pioneer in this field was Young-Rae Cho, an outstanding human rights lawyer who was himself an ardent democratic activist and was even imprisoned under the charge of seditious conspiracy in the 1970s. In the late 1980s, he led a number of seminal lawsuits during his time as an attorney, including the *Mangwondong* flooding case[11] and the retire-at-marriage case.[12] After Young-Rae

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9 <http://www.peoplepower21.org/English/39340>.

10 <http://www.peoplepower21.org/English/39340>.

11 This was a lawsuit brought on behalf of over 2,500 households that suffered serious damage from flooding in 1984, which was organized by *Young-Rae Cho* and directed against Seoul Metropolitan Government and the Hyundai Construction Corporation for their negligence in constructing and managing the floodgate system. It was not technically a class action suit, but was by far the largest group litigation in Korean history at the time. The plaintiffs ultimately won the case in 1990, symbolizing the new post-democratization order of the rule of law.

12 This was a typical personal injury case involving a traffic accident, but the issue was how to calculate the loss of income of the plaintiff, who was an unmarried female worker. The

Cho's premature death in 1990 at the age of 43, his legacy was embodied in discourses on topics such as "public interest law" and "public interest attorneys," which were further developed by his former colleagues and successors. *Mangwondong* and the other cases led by Cho served as a prototype for other collective suits[13] that purported to serve the "public interest" rather than the private interests of the plaintiffs. PSPD's shareholder activism also stemmed from Cho's legacy. The group attempted to employ litigation and other legal measures for the purpose of social reform in accordance with the spirit of the "public interest law" movement.

However, PSPD's (in particular the EDC's) key members were not simply idealists lacking professional expertise. Rather, most of them were elites equipped with professional licenses or a higher academic education. A glance at key members of PSPD, in particular the EDC, reveals that their activism was based on a significant level of expertise and that their influence on Korean society to date has been more than anecdotal. *Won-Soon Park,* a principal founder of PSPD and a former colleague of *Young-Rae Cho,* was already a renowned human rights lawyer in 1994. He was elected as the mayor of Seoul three times in a row in 2011, 2014 and 2018. As of 2018, he is one of the ruling party's promising potential candidates for the next presidential election. *Hasung Jang,* who has a PhD in finance from Wharton and is a co-author of several articles published in top journals,[14] was a professor at Korea University in 1994. His active presence and poignant remarks at the general shareholder meetings of large conglomerates such as Samsung Electronics received great media attention. In 2017 he was appointed as the Secretary of Policy of the Presidential Office. Sang-Jo Kim, an economics PhD and university professor, also actively represented minority shareholders at general shareholders meetings together with Hasung Jang and other PSPD colleagues. As a consistent activist arguing for the reform of large conglomerates (also known as *chaebol*), he was appointed to lead the Korea Fair Trade Commission in 2018; the Korea Fair Trade Commission is a powerful government agency in charge of promoting competition and regulating *chaebol.*

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trial court calculated her lost income based on the assumption that she would retire when she got married in her mid-20s (age 26 was the court's presumption), as was the custom at the time. In 1986, *Young-Rae Cho* succeeded in overturning the decision at the appellate court, which held that her retirement age should be the same as that of her male colleagues, this age being 55, for the purpose of calculating lost income. It was a powerful challenge to the traditional practice and perception that female workers, and particularly those engaged in manual labor, usually retired or were forced to retire when they got married.

[13] P. GOEDDE, The Making of Public Interest Law in South Korea via the Institutional Discourses of *Minbyeon,* PSPD and *Gonggam,* in: Yang (ed.), Law and Society in Korea (Cheltenham 2013) 132.

[14] For example, B. BLACK/H. JANG/W. KIM, Predicting Firms' Corporate Governance Choice: Evidence from Korea, Journal of Corporate Finance 12 (2006) 660.

Among the junior members of the EDC, many were also professional elites and are still influential. *Jooyoung Kim,* who had practiced corporate and securities law at a major private law firm in Seoul before joining PSPD, was the person who actually represented PSPD in the courtroom. As of 2018, he is still one of the most influential figures of the plaintiff's bar in the field of securities and derivative litigation. He was recommended by the Korean Bar Association in August 2018 as one of three candidates for the Supreme Court Justice. *Joongi Kim,* a Columbia JD and New York lawyer, was (and still is) a professor at Yonsei University.[15]

This team of elite activists in PSPD's EDC employed various legal methods against *chaebol* companies as a part of the social reform movement. Under the legacy of *Young-Rae Cho* and other democratic activists of the 70's and 80's, PSPD's motives were mainly sociopolitical. The EDC was less politically driven and more "capitalistic" in nature compared with the other sections of PSPD, but it was still a part of PSPD. Through various activities, EDC tried to reform the rigged governance of *chaebol* companies, protect the interests of the minority shareholders, and establish a fair market order.

2. *Activities of PSPD*

a) *Attendance at the General Meetings and Related Actions*

PSPD's initial form of shareholder activism was attending and speaking at a GMS. It challenged the custom of a 'silent' GMS by sending detailed questionnaires in advance and asking questions. Through questioning, shareholders could obtain important information on, and draw public attention to, secret transactions such as unfair subsidies to affiliated companies or transactions with family members of the controlling shareholder.[16] These prepared questions by themselves placed a substantial degree of pressure on management.[17]

Attendance at a GMS sometimes led to exercising further shareholders' rights and engaging in disputes. PSPD often submitted shareholder proposals[18] and sometimes launched proxy solicitations to have the proposed agenda item passed at the GMS. If the company disrupted attendance or questioning, PSPD sought the nullification or cancelation of the resolution in question through lawsuits.[19]

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[15] They co-authored an article in 2001 regarding PSPD's shareholder activism: JOOYOUNG KIM/JOONGI KIM, Shareholder Activism in Korea: A Review of How PSPD Has Used Legal Measures to Strengthen Korean Corporate Governance, Journal of Korean Law 1 No. 1 (2001) 51.

[16] KIM/KIM, *supra* note 15, 57–58.

[17] KIM/KIM, *supra* note 15, 58.

[18] PSPD's first shareholder proposals were made at the general shareholders meetings of Samsung Electronics and SK Telecom in March 1998. KIM/KIM, *supra* note 15, 59.

Examples are plentiful. At the GMS of Korea First Bank in March 1997, PSPD reprimanded its management for providing nonperforming loans to Hanbo Steel, which became insolvent in 1996.[20] At the GMS of Samsung Electronics in March 1998, PSPD raised issues regarding (i) the issuance of convertible bonds to Chairman *Lee's* son at a low convertible price (a type of so-called 'cheap stock tunneling') and (ii) the provision of undue subsidies to its affiliate companies. Mainly due to PSPD's thorough questioning and debates, this meeting lasted for 13 hours and attracted media attention.[21] In 1998, prior to SK Telecom's GMS, PSPD proposed amending the articles of incorporation to elect outside directors, which was accepted by SK Telecom even before the statutory mandate of having outside directors.[22] In 1999, PSPD persuaded 3,000 people to buy shares of selected large companies and represented such minority shareholders at the general shareholders meetings of four companies to raise issues with governance and question suspicious internal transactions. Attendance at general shareholders meetings continued until 2006, when the EDC (renamed the Economic Reform Center) split from PSPD.

b) Derivative Actions

Generally speaking, PSPD (and not just the EDC) employed litigation as an important tool for attaining its goals. There were two main reasons for this. First, lawsuits provide concrete results, and second, other victims besides the plaintiffs in successful lawsuits can find similar relief under the authority of a court decision.[23] Given such a tendency within PSPD, it is no wonder that derivative actions were frequently brought as a legal measure for shareholder activism.

The first derivative action in Korean history was brought by PSPD in 1997 against the directors of Korea First Bank for their negligent lending to a nearly insolvent company. The plaintiff shareholders lost their standing because they came to own no shares during the proceedings due to capital reductions by the company, but since the company itself joined the suit on the plaintiffs' side, the suit was not dismissed and was sustained between the company and the defendants. The final decision was made in 2002 by the Supreme Court in favor of the company (i.e., the defendants were held liable toward the company).[24]

Similar suits followed against the directors of Samsung Electronics (brought in 1998, final decision in favor of the plaintiffs in 2005),[25] Daewoo

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[19] PSPD succeeded in nullifying a resolution of Korea First Bank in 1997, but failed in a similar case against Hyundai Heavy Industry in 1999. KIM/KIM, *supra* note 15, 58.

[20] It resulted in bringing the first derivative action in Korean history.

[21] KIM/KIM, *supra* note 15, 58.

[22] KIM/KIM, *supra* note 15, 59.

[23] GOEDDE, *supra* note 13, 137.

[24] Korean Supreme Court, 15 March 2002, 2000Da9086.

[25] Korean Supreme Court, 28 October 2005, 2003Da69638.

Corporation (brought in 1999, decision against the plaintiffs), LG Chemical (brought in 2003, decision in favor of the plaintiffs in 2006),[26] and Daesang Corporation (brought in 2005, decision in favor of the plaintiffs). This series of lawsuits significantly changed the atmosphere inside the board rooms of large Korean companies, as the possibility of being sued by shareholders became a real concern.

In order to collect information and evidence before bringing a derivative suit, PSPD often demanded an inspection of the books and records pursuant to Art. 466 KCC. In some cases, PSPD filed for an injunction to stop certain related party transactions pursuant to Art 402 KCC, which entitles shareholders to demand directors "cease illegal activities." Even before filing a lawsuit or injunction, some companies voluntarily accepted such demands. For example, in 1999 Hyundai Heavy Industries withdrew their plan to support Hyundai Motors in its acquisition of Kia Motors and Asia Motors by agreeing to PSPD's demands.[27] PSPD's demands sometimes served as an excuse to refuse requests for help from sister companies, as Hyundai Heavy Industries refused a request from the Hyundai Group during the course of Hyundai Engineering and Construction's financial crisis.[28] One may argue that PSPD unduly interfered with business judgment of management. But, considering the presence of the controlling shareholder in Korean *chaebols,* PSPD's activism granted "[…] more authority and discretion to a professional manager by giving them a useful tool to refuse improper demands driven by controlling shareholders."[29]

c) Criminal Accusations

In egregious cases, PSPD filed criminal complaints with the prosecutor's office. Under the Korean Criminal Code, a breach of fiduciary duty may constitute "criminal breach of trust" or embezzlement of corporate assets. As a famous example, in 1999 PSPD accused the directors of Samsung SDS of issuing bonds with warrants to the Chairman's son at a price lower than fair market price. PSPD also accused (i) the CEO of Hyundai Securities in 2001 of providing payment guarantees to its affiliate, (ii) the management of Hanwha Group companies in 2002 of accounting fraud, (iii) the Chairman of the SK Group in 2003 of unfair related party transactions, and (iv) the management of the Doosan Corporation in 2005 of providing undue financial support to the controlling family members.[30] Many accusations led to criminal convictions against the management or controlling family members of large conglomerates, and some of them were used as evidence in subsequent civil actions.

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26 Seoul Southern District Court, 17 August 2006, 2003gahap1176.
27 KIM/KIM, *supra* note 15, 64.
28 KIM/KIM, *supra* note 15, 64.
29 KIM/KIM, *supra* note 15, 65.
30 <http://www.peoplepower21.org/Economy/1143268> (in Korean).

3. *Contributions and Limits of PSPD's Campaigns*

a) Contributions

PSPD's activism invoked various minority shareholders' rights that had remained dormant for decades.[31] It brought the first shareholder derivative action in Korean history, and virtually rediscovered the shareholder powers stipulated in the KCC, such as a shareholder's proposal right, the right to convene a GMS, the right to inspect corporate books and records, and the right to ask questions at a GMS.

Invoking such rights and powers of shareholders had *ex-post* and *ex-ante* effects. As *ex-post* effects, the act of filing a lawsuit succeeded in publicizing an alleged wrongdoing and embarrassing the named violator, possibly forcing concessions outside the courtroom.[32] Directors who committed wrongdoing were forced to pay damages and were sometimes even imprisoned. More importantly, as *ex-ante* effects, it increased the transparency of the corporate decision making process in large Korean companies and prompted careful reviews by the board of directors. Before PSPD invigorated the rights of shareholders, the possibility that a director would be held liable for a breach of fiduciary duty was quite remote and mostly theoretical. After PSPD's activism, however, it became a real risk. When requested by management to approve a suspicious related party transaction, the directors of large companies began to fear potential liability and became reluctant to give their blessing without careful review. These were all positive effects.

b) Limits

PSPD's shareholder activism had its own limits. First of all, there was a serious bias in selecting targets. Because PSPD was largely motivated by a sociopolitical agenda and wanted to maximize its impact on Korean society, it targeted large and famous companies that could attract media attention. Ironically, the companies targeted by PSPD (e.g. Samsung Electronics, SK Telecom, LG Chemical) were some of the best performers in the Korean economy in terms of profits and shareholder value, and had relatively better corporate governance than most other companies. Companies that had much more serious governance issues were not targeted if they were not famous enough to attract public attention.

In addition, shareholder activism, which inherently focused on maximizing shareholder value rather than interests of other stakeholders, did not comfortably fit with the more progressive viewpoints within PSPD. The relatively moderate or "right-leaning" members of PSPD focused on tunneling within *chaebol* groups and tried to protect minority shareholders, while the more progressive or

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[31] KIM/KIM, *supra* note 15, 54.

[32] GOEDDE, *supra* note 13, 139.

"left-leaning" members of PSPD regarded the concentration of economic power by *chaebols* as a fundamental problem and tried to regulate or even "dismantle" *chaebols*. Derivative actions, active attendance at GMSs, and other legal actions were mainly tools for the former, and were subject to criticism within PSPD that shareholder activism was another form of neoliberalism.[33]

In 2001, the EDC was renamed the "Economic Reform Center" within PSPD. In 2006, the center split from PSPD and took on the new name "Solidarity for Economic Reform." Certain activists left PSPD and entered into alliances with foreign capital, such as the Lazard Fund, to launch the "Korea Corporate Governance Fund." Although Solidarity for Economic Reform has continued similar activism thus far, such as bringing derivative actions, its impact is not comparable to PSPD's. The brilliant but short tale of PSPD left questions regarding the sustainability and efficiency of shareholder activism when it is sociopolitically motivated.

IV. Institutional Investors: The Case of NPS

1. National Pension Service

The National Pension Plan is the nationwide mandatory pension plan of Korea, and the National Pension Service (NPS) is the entity in charge of operating the National Pension Plan. It was established in 1987 "[…] to help secure the retirement benefits of Korean citizens with income security, thereby promoting national welfare in the case of retirement, disability or death."[34] As the world's third-largest pension fund, its assets under management amounted to 634 trillion Won (approximately 550 billion US-Dollar) as of May 2018.[35] Around 130 trillion Won of the total assets are invested in the Korean stock market, directly or through asset management companies.[36] It is presumed that the NPS owns approximately 8% of the total market capital of the Korean stock market. Indeed, it is the largest shareholder for many Korean listed firms.

[33] From such a critical viewpoint, a civic leader was reported to have stated, "We originally wanted economic democracy, yet what we gained was shareholder capitalism." B. DALTON/M. RAMA, Understanding the Rise and Decline of Shareholder Activism in South Korea: the Explanatory Advantages of the Theory of Modes of Exchange, Asia Pacific Business Review Vol. 22 No. 3 (2016) 482.

[34] <http://english.nps.or.kr/jsppage/english/about/about_05.jsp>.

[35] <http://www.nps.or.kr/jsppage/etc/data/data03_01.jsp>. As of May 2018, domestic equity investment directly held by NPS was 69.7 trillion Won and domestic equity investment through asset management companies was 60.4 trillion Won. Overseas equity investment was 40.2 trillion Won in direct ownership and 74.1 trillion Won through asset management companies.

[36] Under the Capital Markets Act, NPS should directly exercise voting rights, even for the stocks it owns through asset management companies.

Given its large shareholding ratio, it has become increasingly difficult for the NPS to simply sell its stock on the market when it is not satisfied with the management of a target firm.[37] Unable to rely on the traditional "Wall Street rule" any longer, the NPS is becoming more inclined towards shareholder activism that can improve the target firm's value.[38] Thus, how and in what directions the NPS exercises its voting rights are becoming more and more critical factors in the management of listed firms.

The NPS's voting policy is declared in the National Pension Act (NPA). The NPS must "[…] exercise voting rights in good faith for the benefit of the fund, and publicly disclose the exercise of voting rights." (Art. 64 NPA). For the purchase and sale of securities, the NPS may "[…] consider such factors as environment, society, and governance relevant to the target securities in order to secure long-term and stable increase of earnings." (Art. 79 NPA) Also, the NPS has a "Fund Management Guideline" which stipulates "5 Principles" – namely profitability, stability, public concern, liquidity, and independence – for fund management. However, these broad rules and principles are insufficient to guarantee the NPS's active engagement as a large shareholder.

Is the NPS actively exercising its voting rights? In 2015, out of 791 portfolio companies, the NPS attended the GMS of 749 companies and exercised voting rights for 2,836 agenda items. Among them, the NPS voted in favor of an agenda item 2,542 times (89.6%) and against an agenda item 283 times (10.1%). It may appear that the NPS is generally casting affirmative votes, but its disapproval rate is much higher than that of other institutional investors (2.2% in 2015).

Table 2: "Vote No" Rates by the NPS

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015
Rate of "Vote No"	5.0%	5.4%	6.6%	8.1%	7.0%	17.0%	10.8%	9.0%	10.1%

Source: Press release of NPS dated 14 December 2016 (in Korean).

Table 2 shows that the NPS's rate of disapproval ("vote no") at GMSs is generally on the increase. A recent empirical study that investigated stock price reactions to an NPS "vote no" press announcement found that "[…] shareholder activism by the NPS is effective in increasing the valuation of target companies when it improves internal corporate governance."[39] *Table 2*

[37] S. KIM/H. BYUN/E. LEE, Does "Vote No" Change Corporate Governance and Firm Value? Evidence from the Shareholder Activism of the Korean National Pension Service, Emerging Markets Finance & Trade 50, No. 5 (2014) 50.

[38] KIM/BYUN/LEE, *supra* note 37, 52.

[39] KIM/BYUN/LEE, *supra* note 37, 57. More specifically, this research found that (i) firms that experienced a "vote no" were more likely to improve the activities of the

also shows that the rate of disapproval was exceptionally high in 2012. What happened in 2012 is the first episode discussed below.

2. *Episodes of the NPS's Activism*

a) *Episode 1: Limiting Directors' Liability in 2012*

Article 400 para. 2 KCC, which was newly added in 2011 and took effect in April 2012, addressed the business community's longstanding concern about excessive liability. It provided that "[…] a company may set a ceiling for directors' liability toward the company in its articles of incorporation." The ceiling must be no less than six years' compensation (for non-outside directors) or three years' compensation (for outside directors). The ceiling does not apply to liability for incidents caused intentionally or through gross negligence, or incidents that arise out of conflict-of-interest transactions.

Many companies tried to set a ceiling by amending their articles of incorporation at their annual GMSs in March 2012. However, they had to confront opposition by the NPS. The NPS decided to oppose such amendments because they would decrease directors' incentives to exert their fiduciary duty. At the annual GMS for many firms, the NPS voted against such amendments. For many other firms, the NPS succeeded in persuading the board of directors not to propose such an amendment to the annual GMS. In such cases, the NPS did not even have to vote "no". Although the precise number is not known, out of the hundreds of companies that attempted to amend their articles of incorporation to limit directors' liability, at least dozens of companies failed because of the NPS's opposition. This episode showed that the NPS's power was strong enough to prevent changes to articles of incorporation in accordance with the amended statute.

b) *Episode 2: Halla Group Case in 2013*

The NPS played a crucial role in a dispute concerning the Halla Group's suspicious transactions in 2013. Halla Construction (HC), the flagship company of the Halla Group, was struggling to overcome financial distress. Mando, a listed firm that manufactures automobile parts, was the Halla Group's most profitable company and the only affiliate that could help HC. However, Mando's equity investment in HC was legally not allowed. Because HC held 19.99% of the issued shares of Mando, Mando's equity investment in HC would constitute "cross shareholding," which is prohibited in large business groups under the Monopoly Regulation and Fair Trade Act of Korea.

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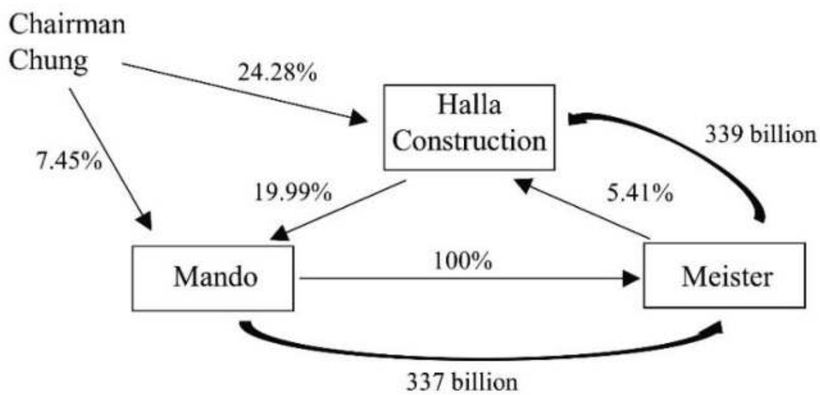
board of directors and (ii) if the NPS voted against the election of directors or statutory auditors and these "vote no" activities improved the target firm's corporate governance, such as the function of the board and the structure of the audit committee, then the "vote no" activities increased the target firm's valuation.

Figure 1



In order to circumvent the prohibition on cross holding, the Halla Group tried circular shareholding as shown in *Figure 1.* On 12 April 2013 Mando invested 377 billion Won in Meister, and on 16 April, Meister in turn invested 339 billion Won in HC. These decisions by the three companies – that is, (i) Mando's decision to invest in Meister, (ii) Meister's decision to issue new shares to Mando and invest in HC, and (iii) HC's decision to issue new shares to Meister – were made on the same day (12 April 2013). As a result, HC succeeded in financing 339 billion Won in equity, in effect from Mando's funds.

This transaction had serious problems. First, Mando's equity investment in HC (through Meister) did not have any business justification. Second, the circular investment increased the aggregate book value of the Halla Group without any substantive increase in assets, which created the illusion of an improved financial structure for the group. Third, it increased affiliates' shareholding ratio among the three companies and thus strengthened their ability to make unreasonable decisions. Fourth, given that the controlling shareholder had higher stakes in HC than in Mando, Mando's financial assistance to HC constituted traditional tunneling. In sum, it was a bad business decision that resulted in bad accounting, bad governance, and harm to the non-controlling shareholders of Mando.

Among Mando's institutional investors, Trustone, a local stand-alone asset management company not affiliated with any large business group, was the first to raise an issue in collaboration with NPS. It filed an injunction with the court on 15 April against Meister to stop its investment in HC. On the same day, Trustone and the NPS paid a "protest visit" to Mando management and launched a public campaign. Trustone, supported by the NPS, demanded the convocation of an extraordinary GMS and considered taking further legal actions such as shareholder proposals and derivative actions. After discussions with Trustone and the NPS, Mando management agreed to hold an extraordinary GMS and elect an independent director nominated by Trustone.

Pursuant to such an agreement, Trustone's nominee was elected in June 2013 as an independent director of Mando representing institutional investors. Although the transaction itself was not unwound, further tunneling was prevented by improving Mando's governance.

This episode showed the importance of coalition-building among institutional investors and the power of the NPS, given that Trustone did not have leverage over the management of Mando without the cooperation of the NPS. The market's reaction to the activism of the NPS was also affirmative. Mando's stock price hit its lowest point on 16 April, immediately after the transaction, but recovered after the extraordinary GMS and the improvement of Mando's governance.

c) Episode 3: Cheil and Samsung C&T Merger in 2015

In 2015, two Samsung Group affiliates, Cheil Industries (a textile manufacturer also operating an amusement park) and Samsung C&T (a construction and trade company), entered into a merger agreement. Both companies were publicly traded on the Korea Exchange, but the controlling family members' direct ownership was much higher in Cheil (42.2%) than in Samsung C&T (1.4%).

Under the Capital Markets Act of Korea, the price for a merger between two listed companies is determined pursuant to a statutory formula. The standard market price (SMP) of each company's share is calculated as an arithmetic average of (i) a trade volume weighted average of closing prices during the one-month period prior to the board resolution of merger, (ii) a trade volume weighted average of closing prices during the one-week period prior to the board resolution of merger, and (iii) the closing price of the trade day immediately preceding the board resolution of merger. The merger price of each company's share must fall within 10% above or below the SMP. In this case, the merger ratio based on the SMP was 1:0.35, meaning that one Samsung C&T share would be converted into 0.35 Cheil shares after the merger.

From a comparative law perspective, it is very unique that a statute provides a formula for merger pricing – in most other jurisdictions, the merger price is determined by a contract between the parties and its reasonableness may be subject to an *ex-post* review. On the contrary, with the intention of preventing arbitrary pricing in a merger, Korean law mandatorily applies recent market prices. If the market prices are reasonable, as the efficient market hypothesis assumes, the Korean law approach might make sense. However, in this merger, many experts opined that the statutory merger ratio was unfavorable to the shareholders of Samsung C&T because its shares were seriously undervalued in the market.[40] ISS and other proxy advisers unani-

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[40] Samsung C&T's PBR (price book value ratio) was 0.65, while Cheil's PBR was 4.8 according to the prospectus. This meant that Samsung C&T's market capital was around

mously advised Samsung C&T's shareholders not to approve the merger.[41] However, the NPS, which held 11.2% of the total voting shares of Samsung C&T (and also some shares in Cheil), voted for the merger at both companies' extraordinary GMS. Without the NPS's cooperation, the merger would have been disapproved at the extraordinary GMS of Samsung C&T.[42] Certain shareholders of Samsung C&T, including Elliot Associates L.P., brought various injunctions to stop the merger and lawsuits to nullify the merger, but all of them were dismissed.

This became a nationwide scandal in late 2016. The former minister of health and welfare was indicted for having exercised undue pressure on the NPS to vote for the merger, allegedly at the direction of the president. The former head of NPS Investment Management, a division within the NPS in charge of managing the National Pension Fund, was also indicted for criminal breach of trust based on the accusation that he decided to vote for the merger in breach of his fiduciary duty toward the NPS, thereby causing damage to the NPS. Both of them were sentenced to imprisonment by the trial court and the appellate court.[43] Regardless of the final conclusion, these cases serve as a reminder that there is always a serious concern over the influence of political power on the investment decisions of, and the exercise of voting rights by, the NPS.

3. *Remarks*

The aforementioned episodes show that the NPS may have an incentive for shareholder activism, but in a very limited manner. The NPS as a separate organization (and its executives and employees as well) will be better off when it succeeds in maximizing the value of its assets under management.[44] Thus, there exists an incentive for the NPS to maximize the aggregate value of the stocks of portfolio firms. Such an incentive, however, does not automatically translate into an incentive for shareholder activism. In order to recognize an incentive for shareholder activism, there should be a link between active engagement as a shareholder and an increase in the value of portfolio firms. Such a link will be found, for example, when there is need to prevent tunneling by management that is clearly harmful to the company, or to prevent clearly negative changes to

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65% of its liquidation value. Its market capital was even lower than the market value of the shares of Samsung Electronics and Samsung SDI that Samsung C&T owned.

41 ISS suggested 1:0.95 as a proper merger ratio, which was a much higher valuation of Samsung C&T shares than the statutory ratio of 1:0.35. Corporate Governance Service, a local proxy adviser, suggested 1:0.42.

42 The minimum votes Samsung C&T needed to approve the merger were two thirds of the voting stock present at the GMS. The approval rate was 69.5% (just 2.8% above the two-thirds threshold), including NPS's 11.2%.

43 The cases are pending at the Supreme Court as of August 2018.

44 This will come in the form of expanding the organization, increasing its budget, making promotions easier, and increasing salaries or performance-based compensation.

the articles of incorporation. Episodes 1 and 2 occurred in this context. But even in such cases, the incentive was not strong enough to urge the NPS to take more aggressive legal actions like PSPD did.

More serious concerns are raised about the independence of the NPS. Being under the government's control,[45] the NPS may be exposed to demands from the government and politicians. Such demands may be politically driven or even due to corruption, as was the case in Episode 3. Fundamental reform of NPS governance is critical in getting rid of such concerns and justifying the active engagement of the NPS as a major shareholder of Korean companies.

V. Closing Remarks

Around the turn of the century, PSPD's shareholder activism invigorated corporate laws that had remained dormant for decades and made significant contributions to improving the governance of Korean companies. Ironically, however, its sociopolitical motives made it focus on large and famous companies that had relatively better governance. Often criticized as "shareholder capitalism" or "neoliberalism" by more progressive civic activists, PSPD's shareholder activism turned out to be unsustainable. In the 2010s, the NPS has exercised its power as a major shareholder to prevent harm to its portfolio companies, but its activism has been limited and not free from suspicions of political interference. Now the Korean economy needs a new type of shareholder activism that is efficient, sustainable, and driven by economic rather than political motives.

In this regard, a stewardship code is worth a brief mention. A stewardship code is a set of principles on how institutional investors should act as the shareholders of companies in which they invest.[46] Since the Financial Reporting Council of the UK adopted one in July 2010, a number of countries have followed. Their details are not identical, but the codes generally urge institutional investors to engage more actively with their portfolio companies by exercising their rights as shareholders.

The Korean version of a stewardship code was adopted in 2016 by the Korea Stewardship Code Council, a non-governmental body composed of experts in the private sector. It declares broad and abstract principles. For example, institutional investors should (i) formulate and publicly disclose a clear policy to carry out their responsibilities; (ii) regularly monitor portfolio companies in order to enhance their mid- to long-term value; (iii) regularly

[45] For example, the head of the NPS is appointed and removed by the president upon the recommendation of the minister of health and welfare (Art. 30 para. 2 NPA).

[46] G. GOTO, The Logic and Limits of Stewardship Codes: The Case of Japan (unpublished draft), 1–2.

report their voting and stewardship activities to their clients or beneficiaries; and (iv) have the capabilities and expertise required to carry out their stewardship responsibilities. The success of the Korean version of the stewardship code depends on whether or not, and to what degree, the NPS will adopt and implement this code. If the NPS exercises its rights as a shareholder pursuant to a stewardship code, and requires its trustee companies (i.e., the asset management companies that manage portions of the National Pension Fund) to adopt and implement the code as well, the management of Korean listed companies will have to pay much more attention to enhancing shareholder value. Shareholder activism will be able to take a form of "sustainable engagement," as opposed to the ad hoc legal actions that were once pursued by PSPD.

Scholars in the US are generally skeptical about the approach of "stewardship" or "sustainable engagement" that is prevalent in Europe.[47] They question institutional investors' capabilities and incentives to monitor portfolio companies and argue that hedge funds have such incentives and expertise regarding monitoring and activism.[48] Their role is to "potentiate institutional voices" and increase the value of votes held by "rationally reticent" institutional investors.[49] These hedge funds provide a form of "market-based stewardship" and act as "governance intermediaries."[50]

Is there any prospect for hedge fund activism in Korea as anticipated by US scholars such as Gilson and Gordon? Probably not in the near future, at least not in the manner praised by them. The NPS's dominance in the Korean capital market does not easily create room for a hedge fund to act as a governance intermediary. Setting aside the NPS, other institutional investors' portions of the market would be too small for any meaningful intermediary activity. In addition, hostile sentiment towards foreign hedge funds among the Korean people may be another barrier.

At least over the next decade, the NPS will still hold the key to a desirable form of shareholder activism in Korea. The critical issue is how to incentivize the NPS to actively protect shareholder interests and, at the same time, how to insulate it from pressure by the government and politicians. The NPS must find inspiration in PSPD's enthusiasm in pursuing their goals and their creativity in taking legal actions, but the NPS also needs to be careful not to allow political motives to influence its exercise of shareholder power. These are the lessons offered by the shareholder activism that has taken place in Korea over the past two decades.

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[47] For instance, R. GILSON/J. GORDON, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, Columbia Law Review 113 No. 4 (2013) 863; J. COFFEE/D. PALIA, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, Annals of Corporate Governance 1 No. 1 (2016) 1.

[48] GILSON/GORDON, *supra* note 47, 866, 867.

[49] GILSON/GORDON, *supra* note 47, 867, 906.

[50] GILSON/GORDON, *supra* note 47, 867.

II. Disclosure of Substantial Holdings

Disclosure of Substantial Shareholdings in Stock Corporations*

A German and European Perspective

Gregor Bachmann

I. Introduction: Some Policy Questions

Before we start to look at the development of the disclosure regime in Germany, it is important to first reflect on a few questions every lawmaker must tackle when considering whether to regulate the disclosure of significant shareholdings:

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Should there be a disclosure regime at all?

At first glance, this question should be answered in the negative. Why mandate disclosures since issuers of shares can already require registration of shares in a share register? However, share registers are not open to the public, and shareholders may not always be registered under their own (or even a real) name.[1] Stock exchanges often require that shareholders register a financial intermediary or another agent in the share register to allow book-entry transfers on the shareholder's behalf, which facilitates the settlement of share transfers.[2] Moreover, some jurisdictions, such as Germany, allow for so-called bearer shares, which provide the company with no way of ascertaining who actually owns its shares or how the overall shareholding is structured.[3]

Although modern legislation, mainly triggered by the zeal to prevent money laundering, tries to limit the use of anonymous shares, it does not completely forbid it. German law, for example, requires that "share certificates are in registered form", but "they may be in bearer form if the company is listed on the stock exchange".[4] In fact there is a good reason why shareholders, at least as a rule, are granted the right to remain anonymous; this anonymity might encourage people to invest large amounts of their wealth into a corporation in the first place. On the other hand, due to issues such as money laundering, disguised stock ownership may pose significant risks both for markets and societies. Therefore, every modern jurisdiction has answered the first question raised here with a resounding "yes".

Who should regulate disclosures?

A second question is whether the disclosure regime needs to be established by state law or whether its design and enforcement can be left to private actors such as stock exchanges. This question leads into a fundamental debate of corporate and securities law that cannot be taken on here.[5] It suffices to say that most jurisdictions have chosen the first path, as will be illustrated hereinafter for Germany. Within federal systems, the follow-up question is whether the upper-level

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[1] Under German law, however, in such cases the company may ask for the details regarding the real owner, see § 67 para. 4 sent. 2 AktG.

[2] A. CAHN/D.C. DONALD, Comparative Company Law (2nd ed., Cambridge 2018) 715.

[3] CAHN/DONALD, *supra* note 2, 715.

[4] § 10 para. 1 AktG. The reason for the latter is that listed companies are subject to the disclosure rules described in this paper (see *infra* at II. and III.). Until 2016, bearer shares were also possible for non-listed companies, but the international "Financial Action Task Force" on money laundering (FATF) admonished Germany to change its law, which was done by the *"Aktienrechtsnovelle 2016"*.

[5] For a general discussion of mandatory disclosure see R. KRAAKMAN et al., The Anatomy of Corporate Law (2nd ed., Oxford 2009) 277 et seq. See also *infra* note 8 (on the French system).

legislator (Federation, Union) or the lower level legislator (Member States) should be equipped with the respective lawmaking powers, or whether there should be competing grants of legislative power.[6] The European Union (EU) has opted for a compromise: the basic standards for mandatory disclosure of shareholdings are set out in an EU directive, but it is up to the Member States to transpose those standards into national law and to add more rules.[7]

Which thresholds should be established?

Once a lawmaker has answered the first question in the affirmative, he has to decide on the inclusivity of disclosure. The easiest approach would be to refrain entirely from establishing thresholds and to simply require any single shareholding to be made public. However, considering the frequent trading of listed shares, this approach would not only be highly impracticable but also extremely costly. It would also go beyond what is necessary for enhancing transparent stock markets. Thus, most jurisdictions have established some form of notification thresholds, usually starting at something like 3% of shares and moving up in more or less tight steps.[8] Every crossing of a new threshold triggers a new notification requirement. Where to set the steps is an imprecise decision, although regulators sometimes try to place them at thresholds for exercising certain shareholder rights.

Should we require the disclosure of shares or voting rights?

Disclosure may be required for ownership of shares, for voting rights or for both. As voting rights are usually attached to shares, the question does not seem to make much of a difference. However, despite the fact that many scholars and jurisdictions favor a system of "one share – one vote", shares and votes can differ sometimes. Most jurisdictions allow for non-voting shares, sometimes called "preferred shares", and some allow for the issuance of shares carrying more than one vote.[9] Therefore, modern capital market law usually refers solely to the holding of voting rights. However, public policy

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[6] For a thorough debate of vertical competition among lawmakers see G. BACHMANN et al., Regulating the Closed Corporation (Berlin 2014) 201 et seq., 225 et seq. (exemplified in European corporate law).

[7] See *infra* II.2.a) and c). For a definition of the directive as a legal instrument of the EU see Art. 288 TFEU: "A directive shall be binding as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods".

[8] For a comparative account see R. VEIL, European Capital Markets Law (2nd ed., Oxford 2017) § 20 para. 22 et seq. French law allows for issuers to set (additional) thresholds in their articles of association, see VEIL, *ibid.,* para. 27.

[9] German law allows for a maximum of 50% of non-voting shares (cf. § 139 para. 2 AktG), but it does not allow for multiple-voting shares (see § 12 para. 2 AktG: "Multiple voting shares shall be prohibited").

statutes, such as anti-money-laundering rules, usually require the disclosure of both voting rights and shareholdings.

How can the loopholes be closed?

As history shows, every sort of disclosure regime provokes attempts by market participants to sidestep the rules because they like to keep their secrets. As in tax law, legislators trying to establish a disclosure regime for capital markets are therefore permanently faced with the difficult task of closing gaps. Just forbidding "circumvention" or "abuse" will not do, as such a broad rule would be hard to enforce and would create severe legal uncertainty. Therefore, you either need a regulatory agency that specifies, on a case-by-case basis or in the form of general guidelines, what structures or schemes are to be subject to disclosure, or the legislator himself has to define what must be disclosed. Many jurisdictions employ a combination of both approaches.

What sanctions should be imposed?

As with any kind of mandatory rules, disclosure requirements need to be enforced. In order to deter violations and to prevent circumvention, smart sanctions must be in place. They need to be severe enough to be effective but must also be proportional to the violation. Also, legislators not only have to decide on the kinds and severity of sanctions but must also consider who should be the one to impose them. Not surprisingly, there are different ways in which legislators have tackled this challenge.

Why require disclosure?

In order to give meaningful answers to questions 1–6, legislators must make up their mind as to why mandatory disclosure is beneficial in the first place. However, since legislators design their regimes mostly in regard to real-world experiences, such as scandalous cases or lobby influence, and not on the basis of theoretical analyses, we will postpone this question. To start with, it seems more appropriate to have a look at an actual example of a disclosure regime along with its historic development. We will return briefly to the question of "why require disclosure" at the end of the paper.

II. The Development of the Disclosure Regime in Germany

1. *Establishing Disclosure*

a) *Disclosure Rules in the German Stock Corporation Act*

Although the German Stock Corporation, the *Aktiengesellschaft* ("AG"), is not officially labeled an "anonymous company", as is its French counterpart, the *Société Anonyme* ("SA"), all its shareholders principally enjoy the right to stay anonymous and hide their identity.[10] Notwithstanding the fact that the company may provide in its articles for rules requiring the registration of shares, shareholders are, as a rule, neither obliged to reveal their real identity to the company nor do they have to make their shareholdings public.

This well-established rule was kept when Germany enacted its new Stock Corporate Act, the *Aktiengesetz* (AktG), in 1937.[11] Although large and influential shareholders had by that time already demonstrated how they could use their power to build up pyramid structures and to form large conglomerates – often to the detriment of minority shareholders – legislators saw no need to rein them in with disclosure rules.

This changed after the war, when Germany undertook a major reform of its Stock Corporation Act, leading to the *Aktiengesetz 1965* (AktG), which is still in force today. The new law required shareholders owning more than 25% of shares to reveal this to the company's management, which in turn disclosed this fact to other shareholders in the company gazette.[12] Shareholders must also notify the management if they later hold over 50% of shares. A shareholder must also report if his percentage of shares falls below one of the two thresholds.[13] The rationale for this is to disclose the loss of control to the public.

In order to prevent a sidestepping of the rules, the AktG provides that shares held by subsidiaries or trustees, or shares which have been acquired but have not yet been transferred, will be attributed to shareholders.[14] Violations of the disclosure requirements result in the automatic loss of rights attached to such shares, including, but not limited to, voting rights.[15]

b) *Disclosure Rules in Securities Law*

In 1995, the disclosure rules of the German Stock Corporate Act were supplemented by disclosure rules in the newly created Securities Trading Act, the *Wertpapierhandelsgesetz* (WpHG). These rules were based on a 1988 EU directive that intended to regularize the disclosure requirements for publicly traded shares within the European Community.[16] The directive required every

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[10] Subject to modern transparency regimes aimed at preventing money laundering etc. (see *infra* III.4).

[11] Prior to that, the rules concerning stock corporations were part of the HGB, as is still the case in many jurisdictions.

[12] See § 20 para. 1, 4 and 6 AktG.

[13] See § 20 para. 5 AktG.

[14] See § 16 para. 4 and § 20 para. 2 AktG.

[15] Cf. § 20 para. 7 AktG. Exempt from these losses are claims for dividends and liquidation proceeds if the notification was not intentionally omitted and has subsequently been made.

[16] Council Directive of 12 December 1988 on the information to be published when a major holding in a listed company is acquired or disposed of (88/627/EEC). This directive is sometimes referred to as the "Transparency Directive I".

EU Member State, including those who had not done so before, to establish a mandatory disclosure regime for shares listed on stock exchanges.

As a minimum standard, the directive set up thresholds of 10%, 25%, 50% and 75% of voting shares as levels that would trigger notification requirements.[17] It also included several circumstances under which voting rights of third persons would be attributed to a shareholder. For example, these circumstances include situations where shares are held by a "controlled undertaking", such as a fully owned subsidiary, or on behalf of other persons, such as a person or entity acting as a trustee, or in a case of "acting-in-concert", where written agreements provide for the concerted exercise of voting rights held by different persons in order to pursue a common policy towards the management of the company.[18] In addition, the directive mandated that voting rights of shares were to be attributed to a person if such person was entitled to acquire those shares and did so through a formal agreement.[19] The directive did not establish enforcement mechanisms, but rather asked Member States to provide for effective sanctions in cases where shareholders did not comply with the disclosure requirements.[20]

In transforming these standards into national law, the German legislature decided to go beyond the minimum requirements of the directive and established an additional notification threshold at 5% of voting rights. In accordance with the directive, the WpHG would apply only to shares that are listed on a stock exchange, exempting them from the parallel disclosure requirements of the AktG, which were kept in place.[21] Owners of non-listed shares were, and still are, subject only to the less stringent notification regime of the AktG. The sanctions for violating the disclosure obligations of the WpHG were basically the same as those in the AktG: the loss of shareholders' rights. In addition, the newly created *Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin* (Federal Agency for the Supervision of Financial Services) was also empowered to impose penalty charges.[22]

2. Extending Disclosure

a) The EU Transparency Directive

Reacting to new developments in capital markets and responding to an increased sensitivity for transparency, the EU revised its disclosure regime and, in 2004, replaced Directive 88/627/EEC with an instrument known as the

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[17] See Art. 4 Directive 88/627/EEC.
[18] Cf. Art. 7 Directive 88/627/EEC.
[19] See Art. 7, 7th indent Directive 88/627/EEC.
[20] Cf. Art. 15 Directive 88/627/EEC.
[21] Cf. § 20 para. 8 AktG.
[22] Cf. § 120 para. 2 no. 2 d) WpHG.

Transparency Directive (TD).[23] The notification requirement and the attribution rules, the core of the old directive, were kept, but some amendments were made. The most important ones were the (moderate) extension of the notification requirements for acquisition rights, which now explicitly mentioned "financial instruments," such as stock options.[24] Also, the disclosure thresholds were extended and were now set at 5%, 10%, 20%, 25%, 30%, 50% and 75% of voting rights.[25] The definition of acting-in-concert, leading to an attribution of shares, was modified and no longer required a "written" agreement.[26]

As the European regime still provided for minimum standards only, Member States were free to set up additional thresholds. Following the model of other jurisdictions, such as Spain and the UK, Germany did so and lowered the threshold for the initial disclosure of shareholdings to 3%.[27] Since the new directive did not ask for specific sanctions, Germany could keep its system of automatic loss of share rights coupled with the threat of penalty charges.

b) "Risk Limitation" and "Investor Protection"

After some German issuers had become "victims" of aggressive hedge funds – most notably *Deutsche Börse AG* in its failed attempt to merge with the London Stock Exchange (LSE) in 2005[28] – the German legislature, partly pushed by lobbyists from corporate board rooms, enacted the *Risikobegrenzungsgesetz* ("Risk Limitation Act") in 2008, which, *inter alia,* intensified the disclosure requirements of the WpHG. The new rules obliged acquirers of "substantial holdings" (≥ 10% of voting rights) to reveal the source of their funds and their strategic aims.[29] Since there are no sanctions for ignoring this duty, this provision has so far been of little relevance in practice.

More importantly, the definition of "acting-in-concert" was extended under the Risk Limitation Act, covering not only the joint exercise of voting rights in the general meeting, but also other less formal means of shareholder coordination with regard to influencing the course of the company. This cre-

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[23] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (Transparency Directive).

[24] See Art. 13 para. 1 TD. The former rule had restricted the attribution of acquisition rights to cases of entitlements "on the person's or own initiative alone, under a formal agreement" (see Art. 7, 8th indent Directive 88/627/EEC).

[25] See Art. 9 para. 1 TD.

[26] See Art. 10 lit. a TD.

[27] Cf. § 33 para. 1 sent. 1 WpHG. For similar or different thresholds in other Member States see VEIL, *supra* note 8, § 20 paras. 22–28.

[28] See A. ENGERT, Hedgefonds als aktivistische Aktionäre, Zeitschrift für Wirtschaftsrecht 2006, 2105 et seq.

[29] Cf. § 34 WpHG.

ated severe legal uncertainty and was heavily criticized by some scholars and practitioners.[30] Moreover, the new regime introduced an accumulation of shares and certain financial instruments in order to prevent the "creeping in" of hedge funds and other predatory investors. Finally, the sanctions were tightened by extending the loss of shareholders' rights to a period of six months after subsequent notification was made, provided that the notification requirements were breached intentionally or by gross negligence.[31]

Once more inspired by dramatic cases, the German legislature soon amended the disclosure regime again. The main purpose of the "Investor Protection Improvement Act" that went into force in 2011 was to close gaps, especially with regard to the use of certain financial instruments. In some prominent cases – notably the *Schaeffler/Continental*-case – acquirers had made use of derivatives such as contracts for difference (CFD), which formally granted them no acquisition rights with regard to shares and therefore did not have to be disclosed.[32] Thus, strategic investors were able to secretly "creep" into the company while remaining below the radar of the disclosure rules. The new law established by that act now also covered financial instruments that do not grant acquisition rights, but that have "a similar economic effect".[33] Also, the law provided for the aggregation of voting rights and other such financial instruments.[34] The reason is to prevent the circumvention of disclosure thresholds by combining shares and financial instruments.

c) *Reform of the EU Transparency Directive (2013)*

The EU followed the example of the German Investor Protection Improvement Act and in 2013 amended the TD in a similar way.[35] The notification

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[30] Cf. H. EIDENMÜLLER, Regulierung von Finanzinvestoren, Deutsches Steuerrecht 2007, 2116.

[31] See § 44 para. 1 sent. 3 WpHG. This rule does not apply "if the actual percentage of voting rights is less than 10 percent higher or lower than the percentage of voting rights indicated in the previously submitted incorrect notification and if no notification is omitted relating to any threshold mentioned under section 21 being reached, exceeded or fallen below" (§ 44 para. 1 sent. 4 WpHG).

[32] For a detailed analysis see K.-M. SCHANZ, Schaeffler KG/Continental AG im Lichte der CSX Corp.-Entscheidung des US District Court for the Southern District of New York, Frankfurt School – Working Paper Series No. 100 (2010); D. A. ZETZSCHE, Continental AG vs. Schaeffler: Hidden Ownership and European Law – Matter of Law, or Enforcement, CBC Research Paper No. 39 (2008) (also available at <http://papers/ssrn.com>).

[33] Cf. § 38 para. 2 WpHG, listing, int. al., options, futures, swaps, forward rate agreements and contracts for difference.

[34] See § 39 para. 1 WpHG. Note: The minimum notification threshold of 3% does not apply in this case.

[35] For a detailed account see N. MOLONEY, EU Securities and Financial Markets Regulation (3rd ed., Oxford 2014) 140 et seq.

requirements laid down in the new TD now also apply to the holding of *financial instruments* “which are referenced to shares and with economic effect similar to that of formal acquisition rights, whether or not they confer a right to a physical settlement”.[36] The reason for this is to prevent a secret “creeping” into the company.[37] Like the German law, the directive mentions, as examples of covered financial instruments, options, futures, swaps, forward rate agreements and CFDs.[38] The European Securities and Markets Authority (ESMA), created in the aftermath of the financial crisis in 2011, was mandated with establishing and periodically updating an indicative list of financial instruments that would fall under the extended disclosure requirement, taking into account technological developments in financial markets.[39] ESMA was also given the power to specify cases in which financial instruments would be exempted from disclosure.[40]

Finally, the revised directive provides for an *aggregation* of shares and financial instruments.[41] It also lays down minimum requirements for *sanctions.* Member States must now at least provide for “administrative measures”, such as orders to cease, pecuniary sanctions and the possibility of suspending the exercise of voting rights.[42] Member States are free to provide for additional sanctions or measures, including criminal sanctions and higher levels of penalty charges.[43]

Since German law had already complied with the specifications of the amended directive, only minor changes of the WpHG were necessary. They were implemented in 2015.

III. Additional Disclosure Requirements

Although the above-mentioned notification requirements for major shareholdings are, at least from a practical point of view, the most important ones, it is noteworthy that there are also other disclosure obligations under German law.

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36 Art. 13 para. 1 lit. b TD as amended by Directive 2013/50/EU.

37 “New types of financial instruments […] could be used to secretly acquire stocks in companies, which could result in market abuse and give a false and misleading picture of economic ownership of publicly listed companies. In order to ensure that issuers and investors have full knowledge of the structure of corporate ownership, the definition of financial instruments […] should cover all instruments with similar economic effect to holding shares and entitlements to acquire shares” (Recital 9 Directive 2013/50/EU).

38 Cf. Art. 13 para. 1b 1 TD as amended by Directive 2013/50/EU.

39 Art. 13 para. 1b 2 TD as amended by Directive 2013/50/EU.

40 Cf. Art. 13 para. 4 TD as amended by Directive 2013/50/EU.

41 Cf. Art. 13a TD as amended by Directive 2013/50/EU.

42 For details see *infra* V.

43 Cf. Art. 28b paras. 2 and 3 TD as amended by Directive 2013/50/EU.

1. Takeover Law

The German Takeover Law, the *Wertpapierübernahmegesetz* (WpÜG), requires any person who has attained "control" over a listed company to disclose this fact to the management and to the public.[44] In accordance with takeover regulations of other European jurisdictions, "control" is defined as the holding – directly or indirectly – of at least 30% of the voting rights.[45] This disclosure rule is of little importance because in all cases covered by it, disclosure is already required by the more refined rules of the WpHG. More relevant is the provision that any person intending to make a public offer for shares must publish this decision without undue delay.[46] Once such an offer is made, and as long as it is open for acceptance, the offeror must regularly publish the number of voting rights acquired.[47]

2. German Code on Corporate Governance

Going beyond the requirements of implemented law, the *Deutscher Corporate Governance Kodex* (German Corporate Governance Code), a non-binding code based on the comply-or-explain-principle, recommended disclosure of any holdings of stock by members of the management board or the supervisory board, if such holdings directly or indirectly exceed 1% of the shares issued by the company. This rule was meant to supplement the transparency rules on directors' dealings that are mandated by European law.[48] However, in order to reduce "bureaucracy", the commission responsible for updating the code decided to repeal this recommendation in 2017.[49]

3. Disclosure of Inside Information

Art. 17 of the EU Market Abuse Regulation (MAR) requires issuers of listed shares "to inform the public as soon as possible of inside information which directly concerns that issuer".[50] Whether this ad-hoc disclosure obligation

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[44] See § 35 para. 1 WpÜG.

[45] See § 29 para. 2 WpÜG.

[46] § 10 para. 1 WpÜG. This rule is based on Art. 6 para. 1 of the European Takeover Directive (Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids).

[47] Cf. § 23 WpÜG. This rule is based on Art. 6 para. 2 of the European Takeover Directive (see *supra* note 46).

[48] Cf. Art. 19 Market Abuse Regulation – MAR (= Regulation (EU) No 596/2014).

[49] For a critical assessment see G. BACHMANN, in: Kremer et al., Deutscher Corporate Governance Kodex (7th ed., Munich 2018) 6.1, para. 1615.

[50] Note: The former *Directive* on Market Abuse (MAD) was, in 2016, transformed into a *Regulation* on Market Abuse (MAR), see *supra* note 48. The difference is that a regulation is "binding in its entirety and directly applicable in all Member States", see Art. 288 TFEU and *infra* note 7 (definition of directive).

also applies to changes in major holdings is not entirely clear, as the question was not decided by the European legislature, and the TD does not define its relationship to the MAR. As the definition of inside information is rather broad, it cannot be ruled out that significant changes in shareholdings, if they have a potential impact on the share price, are to be considered inside information. Whether this is the case cannot be decided in the abstract; instead it must be determined by looking at each individual case.[51]

4. *(Anti-)Money-Laundering Law*

The German rules on money laundering, mainly laid down in the Money Laundering Act, *Geldwäschegesetz* (GWG), are based on the European directive against money laundering.[52] They require the transparency of "beneficial ownership" in a public register. For that purpose, anyone controlling a legal entity is obliged to disclose this fact plus his identity to the entity, which in turn must then file this information with the transparency register (*Transparenzregister*).[53] "Control" in this sense is defined as the ownership of more than 25% of the shares or the holding of more than 25% of voting rights in a German company.[54] However, shareholders of companies that are listed on a German stock exchange or are otherwise subject to disclosure requirements equivalent to that of the TD are exempt from this notification duty.[55]

5. *Further Disclosure Requirements*

Many more statutes mandate, in one way or another, the disclosure of shareholdings, although none of them, except maybe the *GWG,* are as detailed as the WpHG. The German Commercial Code, *Handelsgesetzbuch* (HGB), for instance, requires issuers to disclose in their annual report any direct or indirect shareholdings in the company exceeding 10% of voting rights.[56] By the same token, the Prospectus Law, *Wertpapierprospektgesetz* (WpPG), requires issuers to make public any "major shareholders".[57] The Banking Law, *Kreditwesengesetz* (KWG), obligates any person intending to acquire holdings in a

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[51] VEIL, *supra* note 8, § 20 para. 17.

[52] Directive (EU) 2015/849 of the European Parliament and the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

[53] Cf. §§ 19, 20 GWG.

[54] Cf. § 3 para. 1 GWG.

[55] Cf. § 20 para. 2 sent. 2 GWG.

[56] See § 289a para. 1 (iii) HGB. This disclosure requirement is mandated by the European Takeover Directive (see *supra* note 46).

[57] Cf. § 7 WpPG. This disclosure requirement is mandated by the European Prospectus Directive, cf. Art. 7 Directive 2003/71/EG of the European Parliament and the Council of 4 November 2003.

German bank or a similar financial institution to notify the German financial authority when certain thresholds (10%, 20%, 30%, 50%) will be crossed.

IV. The Current German and European Disclosure Regime

1. Germany

In summary, the current German regulatory regime for the disclosure of major shareholdings can be summarized as follows:

Holders of shares that are *not* traded on a stock exchange (non-listed shares) are only subject to the disclosure requirements of the Stock Corporation Act, meaning that shareholdings must only be disclosed if the thresholds of 25% or 50% are crossed.[58] Violations of these requirements result in the automatic suspension of shareholder rights until proper notification is made.

Holders of *listed shares* are subject to the much more rigid regime of the Securities Trade Act (WpHG). Here, notification requirements are linked not to the ownership of shares but to voting rights. The rules of attribution are broader and cover, in particular, the coordinated conduct of shareholders aimed at bringing about a permanent and material change in the issuer's business strategy ("acting-in-concert").[59] The holding of financial instruments must also be disclosed if they are linked to shares and have an economic effect similar to that of formal acquisition rights. Thresholds start at 3% and move up to 75% of voting rights.[60] Finally, sanctions are stricter as the suspension of voting rights does not end with subsequent notification; rather, it is prolonged for six months if the notification requirements have been breached intentionally or by gross negligence.[61] In addition, the Financial Authorities *(BaFin)* may impose a fine for violating the disclosure rules.

2. The EU-Framework

As described above, most of the content of the German disclosure regime for listed companies is now based on the TD as amended in 2013. The core elements of disclosure are thus the same throughout the European Union. Differences exist mostly in regard to thresholds and sanctions, as the directive, although intended to bring about some form of maximum harmonization,

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[58] Note: Shareholdings in a limited liability company (*Gesellschaft mit beschränkter Haftung* – GmbH) are always disclosed in the commercial register (see § 40 GmbHG: list of shareholders to be filed with the registry). The same holds true for partnerships.

[59] See § 34 para. 2 WpHG.

[60] Note: For financial instruments, the threshold starts at 5% (see *supra* note 25).

[61] See § 44 para. 1 sent. 3 WpHG.

explicitly provides here for minimum standards only.[62] The definition of what amounts to acting-in-concert also differs between Member States.[63] Differences may also result from diverging interpretations of the European standards or from different enforcement practices.[64] The promulgation of guidelines by ESMA may help to overcome such differences.

V. Sanctions

The TD requires Member States to establish certain "administrative measures" in order to ensure compliance with the disclosure regime.[65] Those measures must include a public statement indicating the person or entity responsible and describing the nature of the breach ("naming and shaming"), an order requiring the person or entity responsible to cease the conduct constituting the breach, and pecuniary sanctions of up to 10 million Euros for legal entities and up to 2 million Euros for natural persons.[66] The TD instructs Member State authorities to take into account, when determining the type and level of sanctions or measures, *inter alia,* the gravity and the duration of the breach, the financial strength of the person responsible and the level of cooperation with authorities.[67]

The TD does not exactly define the term "breach". However, Member States must apply the minimum sanctions at least in cases where a shareholder failed to make the required notification at all or where the notification was not made in time.[68] German law goes beyond this minimum requirement and also allows for the imposition of pecuniary penalties in cases where notification was "incorrect", "incomplete" or "not in the prescribed manner".[69] As the preconditions for disclosure of shareholdings are quite complicated, especially in regard to attribution and aggregation rules, and as negligent behavior is sufficient for imposing sanctions, this creates a significant risk for those engaging in transactions. As a result, large and professional investors and

[62] Cf. Recital Art. 12 TD as amended by Directive 2013/50/EU: Member States are allowed to set "both lower and additional thresholds for notification" and "to set stricter obligations than those provided for in Directive 2004/109/EC". See also VEIL*, supra* note 8, § 20 paras. 5–7 and paras. 124–126.

[63] Cf. VEIL, *supra* note 8, § 20 para. 7 note 19 and para. 125.

[64] Note: Enforcement is a matter for the Member State authorities, not ESMA.

[65] See *supra* II.2.c).

[66] Cf. Art. 28b para. 1 TD as amended by Directive 2013/50/EU. Alternatively, the pecuniary sanction may amount to 5% of the annual turnover or twice the amount of the profits gained (for enterprises and for natural persons).

[67] Cf. Art. 28c para. 1 TD as amended by Directive 2013/50/EU.

[68] See Art. 28a lit. b TD as amended by Directive 2013/50/EU.

[69] Cf. § 120 para. 2 no. 2 d) WpHG.

intermediaries should always consult legal experts before executing major transactions in listed shares.

Probably the most important sanction is the suspension of shareholder rights. The TD only requires Member States to provide for the "possibility" of suspending the exercise of voting rights.[70] German law goes beyond this point and provides for an *automatic* loss of *all* shareholder rights, including the right to take part in the annual general meeting (AGM), the right to dividends, and preemption rights in regard to the issuing of new shares.[71] Moreover, the suspension of rights is extended by six months if the notification requirements have been breached intentionally or by gross negligence.[72] This aims to deter strategic investors from hiding their acquisitions until shortly before the AGM.

In practice, the chairman of the AGM – most commonly the chairman of the supervisory board – is charged with the difficult task of determining whether a shareholder has breached her notification requirements and thus must not be admitted to the meeting. Opposing groups of shareholders sometimes accuse each other of breaching disclosure duties in order to prevent the other side from taking part in voting. This has led to proposals for reform, such as replacing the automatic loss of rights with a suspension imposed by a court or another external authority.[73] However, as the automatic suspension of rights is well established in German law,[74] it is unlikely that the German legislature will change this rule in the near future.

VI. Conclusion: Why Disclosure?

1. The Rationales for Disclosure of Major Shareholdings

Let us now return to the policy question left open at the outset of this paper: Why disclosure? "Transparency", sometimes mentioned as the underlying rationale for (every kind of) disclosure regimes, cannot answer that question

[70] See Art. 28b para. 2 TD as amended by Directive 2013/50/EU.

[71] Cf. § 44 WpHG. Dividends may be claimed after the fact provided that the notification was not deliberately omitted and was subsequently submitted.

[72] See *infra* note 31.

[73] Favoring a suspension being ordered by an authority, e.g., C.H. SEIBT, Der (Stimm-) Rechtsverlust als Sanktion für die Nicherfüllung kapitalmarktrechtlicher Meldepflichten, Zeitschrift für Wirtschaftsrecht 2012, 797, 803. For an account of this discussion see G. BACHMANN, Kapitalmarktrechtliche Beteiligungstransparenz im Lichte moderner Finanzinstrumente, in: Fleischer/Kalss/Vogt (eds.), Konvergenzen und Differenzen im deutschen, österreichischen und schweizerischen Gesellschafts- und Kapitalmarktrecht (Tübingen 2011) 207 et seq.

[74] See *supra* notes 59, 60 and 61.

satisfactorily because transparency is not a value in itself. Rather, the question to be asked is how transparency of shareholdings benefits market actors or society at large. Leaving aside the special objectives of anti-money-laundering rules, the reason for which is obvious, one such benefit is that disclosure enables individuals as well as public actors to identify the existence and the holders of *private power* (i.e. social and economic power exercised by non-state actors). If one considers the mere existence of private power, regardless of its effects, as a potential threat to an open society, as does the German tradition of "ordo-liberalism",[75] then the disclosure of major shareholdings becomes part of a larger, meaningful social strategy.

The aim of the TD, however, is a narrower one. It focuses on the positive effects that disclosure in general has for enhancing *efficient capital markets*.[76] The first recital of the TD expresses this clearly: "The disclosure of accurate, comprehensive and timely information […] builds sustained investor confidence and allows an informed assessment […]. This enhances both investor protection and market efficiency".[77] The background to this is the importance of the criteria of shareholder composition and the changes regarding major holdings for an investor's decisions, especially for institutional investors, which is indicated by the significant influence these criteria have on the price of shares.[78] Knowing the identity of major shareholders provides investors with important information, such as allowing them to assess the possibility of conflicts of interest or strategic aims pursued by influential shareholders.[79]

An additional positive effect ascribed to the disclosure of major shareholdings is the prevention of insider trading and of market abuse.[80] Both are prohibited under EU law, as they undermine the confidence of investors about the integrity of the securities market, the protection of which is, according to the regulatory philosophy of EU securities regulation, an indispensable precondition for liquid and efficient capital markets.[81] Moreover, the disclosure of

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[75] See E.-J. MESTMÄCKER, Private Macht – Grundsatzfragen in Recht, Wirtschaft und Gesellschaft, in: Möslein (ed.), Private Macht (Tübingen 2016) 25 et seq. Analyzing the legitimacy of private power from a legal perspective, G. BACHMANN, Die Legitimation privater Macht, in: Möslein (ed.), Private Macht (Tübingen 2016) 603 et seq.

[76] For the very similar, although not fully identical, rationale underlying US securities regulation see J. LOWRY/A. REISBERG, Company Law and Corporate Finance (4th ed., London et al. 2012) 397 et seq.

[77] Recital 1 TD (second sentence).

[78] VEIL, *supra* note 8, § 20 para. 2 (quoting empirical studies).

[79] Cf. EU-Commission, Proposal for a Directive of the European Parliament and of the Council of 26 March 2003 on the harmonization of transparency requirements, COM (2003) 138 final, p. 21.

[80] See VEIL, *supra* note 8, § 20 para. 3.

[81] Cf. Recital 2, 23 of the MAR (*supra* note 48). For a detailed analysis of the development of the EU Insider-Trading Regime and its purposes see G. BACHMANN, Das Europäische Insiderhandelsverbot (Berlin 2015).

financial instruments that enable shareholders to acquire voting rights prevents a secret “creeping” into companies of forces which may be detrimental not only to other investors but also to the management that intends to develop and pursue a sustainable company strategy. For those reasons, the TD, as modernized in 2014, includes such instruments in its disclosure regime.[82]

In sum, the mandatory disclosure regime for major shareholdings is part of a legal strategy that aims to (i) empower investors to make informed decisions and (ii) grow trust in the market. These characteristics are, in turn, supposed to attract investors and thus lead to more liquid and efficient securities markets, which are for their part regarded as prerequisites for economic wealth and prosperity in the European Union.

2. Some Criticism of Total Disclosure of Shareholdings

Although mandatory disclosure of major shareholdings has become a universal element of global securities regulation and is, as such, largely accepted in the academic world, there is some criticism as to the details of such regulation. Apart from the valid claim that transparency is not an aim in itself (see above), the two most frequently raised concerns are that too much disclosure may be counterproductive because it misleads or confuses investors, and that the social costs of complying with and enforcing the complicated disclosure regime are too high.[83] In addition, some fear that an extensive disclosure regime might allow corporate control to suffocate the market and deter activist shareholders, thus benefitting not investors but managers, and that it may not enhance but rather reduce the liquidity of capital markets.[84] These concerns have been fueled by the successful attempts of legislators and regulators to extend the required notifications and to include ever more financial instruments in the disclosure regime.

These concerns have spurred the search for alternative regimes.[85] One model, dubbed the “self-enforcing model”, proposes to tackle secret stakebuilding by groups of shareholders by promising a financial reward to the first participant of the scheme who discloses the holdings or all scheme par-

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[82] See *supra* note 38.

[83] See in particular D. A. ZETZSCHE, Against Mandatory Economic-Only Disclosure of Major Shareholdings in Europe – Twenty Arguments against the CESR proposal, European Business Organization Law Review 2010, 231 (available at: <http://ssrn.com/abstract=1559787>).

[84] See D. A. ZETZSCHE, *supra* note 83.

[85] For a detailed analysis see G. BACHMANN, *supra* note 73, 207, 228 et seq.; see also H. FLEISCHER / U. SCHMOLKE, Das Anschleichen an eine börsennotierte Aktiengesellschaft – Überlegungen zur Beteiligungstransparenz de lege lata und de lege ferenda, Neue Zeitschrift für Gesellschaftsrecht 2009, 401, 403 et seq.

ticipants.[86] Alternatively, some propose only submitting certain "suspicious" holdings of financial instruments to the notification regime, or to require notification to a public authority that would then review the case and decide which course of action should be taken. Such action could be limited to disclosing only the aggregate of financial instruments related to certain shares.[87]

It is not feasible to discuss these and other proposals here. For purposes of this paper, it suffices to say that the devil is in the complicated details, and that no one proposal will be able to simultaneously solve all the problems connected with the disclosure of financial instruments and the attribution of shares. Therefore, the legislature has to make, at some point in time, a decision and establish a certain regime. Both the German and the European legislatures have done so and decided on the disclosure model described above. Giving in to some criticism, and as sort of a compromise, the notification requirement for financial instruments starts only at 5%, and the obligation to disclose one's strategy is triggered only once the threshold of 10% is crossed.

Whether this current regime is a workable one can only be judged by observing its results in the "real world". So far, no major disruptions of capital markets have been reported. It rather seems that intermediaries, as well as investors and authorities, have put up with the disclosure regime as it has evolved over the years. It seems safe to say that this is at least partly due to the fact that highly specialized lawyers, aided by best practice and guidelines from BaFin and ESMA, are able to manage the regime.

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[86] See D. A. ZETZSCHE, Challenging Wolf Packs: Thoughts on Efficient Enforcement of Shareholder Transparency Rules, European Business Organization Law Review 2009, 115 et seq.

[87] Cf. U. WACKERBARTH, Ein Seismograph für Übernahmeaktivitäten, Zeitschrift für Wirtschaftsrecht 2010, 1527, 1532 et seq.

Disclosure of Substantial Holdings in China

A Realm of Order or a Realm of Chaos?

Li Guo

The first national securities legislation in China in 1998 established disclosure rules for substantial holdings that are like those in many parts of the world. These are some of the most fundamental rules for regulating takeover activities and keeping the capital market in order. These rules became more elaborate in the 2005 and 2014 revised versions and remained unaltered in the current Securities Law of China. However, the market went further than the rules. In recently bitter "jungle wars" concerning listed companies' securities and their controlling rights, the existing disclosure rules and the corresponding administrative penalty clause have seemed insufficient to ensure a fair "arena". Thus, other remedies and approaches have been actively sought by various parties in different cases. At the same time, opinions from disparate perspectives have been raised in heated discussions.

This essay intends to analyze and review the disclosure rules for substantial holdings and the administrative punishment measures thereof, mainly through discussing pertinent cases that have been fiercely debated in China. Moreover, it advocates that, as observed from these cases, due to the particularities of the Chinese capital market, the rudimentary disclosure rules should be well respected and strictly complied with. Namely, any violation and any inappropriate benefit obtained therefrom is to be restrained and refrained from. Therefore, as current Chinese securities regulations provide only limited effective remedies or solutions, further steps should be adopted, either in the form of judicial arrangements or of future legislation. In this way, those who deliberately ignore and break the rules in order to stealthily and readily acquire a listed company will not be able to flaunt their disregard for the rules.

I. Rules of the Game: Disclosure of Substantial Holdings and Consequences of Violations in China

In 1998, the original Securities Law of China stipulated in its fourth chapter, "Takeover of Listed Companies", that where an investor comes to hold 5% of shares issued by a listed company, the investor is to, within three days, submit a written report to the securities regulatory authority under the State Council[1] and the stock exchange, notify the relevant listed company and announce the fact to the general public. In addition, within this prescribed period, the investor is not to purchase or sell any more shares of the listed company. These rules also apply to every additional 5% of shares the investor has acquired through trading on a stock exchange after the investor becomes the 5% shareholder of the listed company. Besides this, the investor is not to purchase or sell any more shares of the listed company within the reporting period (three days) and within two days after the report or announcement date.[2]

The 2005 revised version of the Securities Law of China mainly followed the 1998 enactment, and tends to be stricter in three areas.[3] Firstly, it incorporates the shares held jointly by the investor with any other person by means of an agreement or any other arrangement. Secondly, for every additional 5% of shares, the revised rule no longer only refers to those shares acquired through stock exchange trading. It implies that every additional 5% of shares, whether obtained via call auction on a stock exchange or in any other way, for instance through private placement, shall be governed by the disclosure rules. Thirdly, the corresponding penalty clause, Art. 193 of the Securities Law, was added. Since then, the investor has not been able to break the rules at will and faces potential punishment by the administrative authority on violation. According to the clause, the administrative authority can order the relevant party to make rectification, issue it a warning, and fine it between 300,000 and 600,000 Yuan.

In fact, the disclosure rules not only protect the public's right to know, keeping them well informed in a timely manner and diminishing the infor-

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[1] Normally, it refers to the China Securities Regulatory Commission (CSRC).

[2] See Art. 79 of the Securities Law of China (promulgated on 29 December 1998 and took effect on 1 July 1999).

[3] See Art. 86 of the Securities Law of China (promulgated on 27 October 2005 and took effect on 1 January 2006). This article stays the same in the most current amended version (promulgated and took effect on 31 August 2014). Without particular annotation, hereinafter, "Securities Law of China" or "Securities Law" generally refers to the current version, i.e. the 2014 version.

mation asymmetry, thereby enabling the public to make rational investment decisions, but also guarantee fair play in the capital market.

First, it would be easier for the regulatory authorities and institutions to be aware of the ownership changes of listed companies. They can effectively supervise large-scale stock trading and prevent investors from using inside information or capital advantages to conduct securities fraud, such as insider trading or market manipulation. Second, the disclosure rules enable the original management of the listed company to react, evaluate and "defend" in time when confronted with a hostile takeover by rule breakers. Nevertheless, if the rules vanished in some way, there would be no time or opportunity left for the management, and those rule breakers could just sneak into the "backyard" of the listed company and take control overnight.

II. Rule Breakers: Chaos Due to the Gap in Rules

From observation of recent confrontations in the Chinese capital market, the above seemingly complete rules, with both obligations and associated liability for violations, might not be so complete at all. Rather, they leave a major gap for rule breakers to cheat in the capital game without much cost, leading to infinite chaos. Among myriad dramatic cases, *Shanghai Xingsheng Industrial Development (Group) Co., Ltd. v. Binzhong Wang et al.* ("the *Xinmei* case") is a typical example.

1. The Xinmei Case[4]

a) Facts and Plaintiff's Claims

Shanghai Port Machinery Co., Ltd. was listed on the Shanghai Stock Exchange in 1996. After its acquisition and reorganization in 2003, the plaintiff, Xingsheng Industrial Development (Group) Co., Ltd. ("Xingsheng Industrial"), changed the listed company's name to the current one, Shanghai Xinmei Real Estate Co., Ltd. ("Xinmei").[5] While gradually reducing its shareholding in the company, Xingsheng Industrial became the controlling shareholder until 2013, when the defendants snuck into the company without any notification.

According to the judgment, from July to November 2013, one of the defendants, Binzhong Wang, controlled the remaining 15 defendants' accounts (the "account group") and continuously traded Xinmei's shares. When the aggregate shares of the account group exceeded 5% for the first time on

[4] The first trial judgment and second trial adjudication of the case are available in Chinese at China Judgments Online, <http://wenshu.court.gov.cn/> (last visited 12 January 2018). Unfortunately, no English translation is currently available.

[5] Stock code: 600732.

23 October 2013, and then reached 10% on 1 November 2013, the defendants failed to submit any written report, notice or announcement in time. Nor did they disclose that the account group was under the control of the same person or that there was a concerted action relationship.

Before the plaintiff took the suit to court, CSRC Ningbo branch issued an administrative penalty decision[6] to Binzhong Wang on 20 January 2015, for he was the actual controller of the account group and was obliged to fulfill his disclosure obligations. It determined that Binzhong Wang's failure to comply with Art. 86 of the Securities Law constituted an unlawful act under Art. 193 of the Securities Law. Therefore, it ordered him to make rectification, issued him a warning and fined him 500,000 Yuan.

The claims of the plaintiff, Xingsheng Industrial, included:

(1) Determining that the defendants' trading was invalid after their shareholding added up to 5% on 23 October 2013;
(2) Forcing the defendants to sell all the shares acquired on and after 23 October 2013, the profits of which were to be compensated to Xinmei;
(3) Determining that each defendant was to bear joint liability regarding the compensation mentioned in (2);
(4) Deciding that each defendant was not to be entitled to shareholder's rights (for example, proposal rights and voting rights); and
(5) Ordering that the defendants were not to dispose of any of their shares after the administrative penalty decision took effect unless through call auctions or continuous auction.

b) Issues, Decision and Reasoning

Of all the arguments brought up by both sides, the court identified three major issues. First, whether the purchase of Xinmei's shares over 5% was to be considered invalid as a result of the defendants' disclosure violation. Second, whether the legitimate interest of the plaintiff suffered from the defendants' unlawful act. Third, whether the plaintiff was entitled to restrain the defendants from exercising their shareholder's rights or disposing of shares.

After the hearing, the court held that even though the defendants had breached Art. 86 of the Securities Law, which ran counter to the open, fair and equitable transaction principles in the securities market, infringed on public investors' rights, and to a certain extent was detrimental to the stability of the listed company's governance, their illegal activities had already been punished by the securities regulatory authorities. As to the case in question, without any evidence proving the plaintiff's property loss, the plaintiff's claim to prohibit the defendants from exercising their shareholder's rights or

6 The administrative penalty decision is available in Chinese at <http://www.csrc.gov.cn/pub/ningbo/nbxzcf/201512/t20151223_288457.htm> (last visited 12 January 2018).

disposing of shares was untenable, lacking both a factual and a legal basis. Hence, the court dismissed all of the plaintiff's claims.

Concretely speaking, in terms of the first issue, the court confirmed the validity of the transactions and the legality of the defendants' shareholdings. It held that the purchase of shares did not count among the statutory situations which the Securities Law should deem invalid even if it was in breach of disclosure rules. As for civil liability that the defendants might bear for misrepresentation, the court determined that it was beyond the scope of the plaintiff's petition and the court's consideration.

Regarding the second issue, the court found that the plaintiff did not contend that any property loss had resulted from the infringement by the defendants. The court also believed that even though the plaintiff was Xinmei's controlling shareholder, the controlling right and anti-takeover right asserted by the plaintiff were not shareholder's rights that should be protected under the law. Specifically regarding the anti-takeover right, the court explained that it literally constituted neither a legal concept nor a statutory right. Instead, it was just a sort of behavior or measure that the target company's management usually took when they disagreed with the takeover, aiming to prevent the transfer of the company's controlling right and to impede the takeover. Moreover, this could be adopted only when it conformed with the interest of the company and any other shareholder in light of the regulation in Art. 8[7] of the Administrative Measures on Takeover of Listed Companies issued by CSRC.

Pertaining to the third issue, the court held that as the transactions were valid, according to Art. 213 of the Securities Law,[8] it was CSRC that should review and determine whether or not the defendants had entirely fulfilled their rectification obligations and whether they were to be restrained from exercising their voting rights. Since CSRC had taken no further action against the defendants, the plaintiff's claim was not to be supported.

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[7] This article emphasizes that the directors, supervisors and senior managers of a target company assume the obligation of fidelity and diligence, and are to treat all the acquirers equally. The decisions made and measures taken by the board of directors towards the takeover are to be beneficial to maintaining the rights of the company and its shareholders, and are not to hinder the takeover by abusing its authorities, nor are they to provide any means of financial aid to the acquirer by utilizing the target company's resources or damage the lawful rights and interests of the target company or its shareholders.

[8] Pursuant to Art. 213 of the Securities Law, where an acquirer fails to perform its obligations such as announcing the acquisition of a listed company and issuing a tender offer, it is to be ordered to rectify the situation, given a warning and fined between 100,000 and 300,000 Yuan. Before the rectification, the acquirer is not to exercise the voting rights for the shares it holds individually or with any other person through any agreement or other arrangement.

c) The Rest of the Story and Reflection

Obviously, the plaintiff would not be satisfied with the first trial result, so it appealed immediately. Finally, on 22 November 2016, Shanghai High People's Court in its adjudication permitted the withdrawal of the appeal. According to the adjudication, the two sides had reached a settlement outside the court, so the court would not make any further judgment on the first trial result.

Why did the story end in a settlement after the first trial judgment? It must be admitted that if we consider the case solely from a *lex lata* perspective, especially taking the plaintiff's claims into account as well, we can hardly say the first trial court had any misunderstanding of the articles or any apparent logical fallacy in its reasoning and inference.

However, what about considering *lex ferenda*? We can see from the end of the story that the existing law may not be sufficient to reach an ideal and relatively fair result. On the one hand, the controversy was not really settled until the private negotiation by both parties reached consensus outside the court. On the other hand, without any further punishment other than the administrative penalty, the motivation still exists for more rule breakers to cheat in the future. After all, by cost and benefit analysis, this is undoubtedly a "sweet deal". With only the risk of sacrificing 600,000 Yuan at most, the "raiders" can easily grab the controlling shareholder position of a listed company.

2. Other Cases

Though the *Xinmei* case can be counted as quite representative, it is not the only one. The same game and dilemma have also happened in many other cases. Various parties took distinctive approaches when they were faced with similar situations, some of which even led to different outcomes.

Interestingly, in *Guofeng Group Co., Ltd. v. Bo Hu, Biao Hu and Tibet Tourism Co., Ltd.*[9] ("the *Tibet Tourism* case"), the "rule breakers," Bo Hu and Biao Hu, were also sued by the controlling shareholder of the listed company right after the CSRC Tibet branch warned about their breach of the disclosure rules in a supervisory letter.[10] But they were not as lucky as the defendants in the *Xinmei* case. The plaintiff cleverly requested that the court adopt a preliminary injunction.[11] Under the injunction, before an effective judgment, the

[9] Stock code: 600749.

[10] See Announcement of Tibet Tourism Co., Ltd. ("Tibet Tourism") on 24 July 2015, available in Chinese at <http://www.cninfo.com.cn/finalpage/2015-07-25/1201343773.PDF> (last visited 16 January 2018).

[11] According to Chapter 9 of the Civil Procedure Law of the People's Republic of China (2017 Revision), "Preservation and Advance Enforcement", especially Art. 100, when a court has found that it would be difficult to execute a judgment or that any other damage may be caused to a party due to certain behavior, it can adjudicate to issue a preliminary

defendants were not allowed to exercise their voting rights, proposal rights, or rights to participate in, convene and host the shareholders meeting.[12] Although this case also ended up in reconciliation through the court's mediation,[13] there is no doubt that in effect, even prior to any effective judgment, the injunction made before the hearing tended to end this "battle" in a way that favored the plaintiff. Substantially speaking, this is exactly the opposite of the *Xinmei* case.

In two other cases, rather than directly turning to the court for help, the management or original majority shareholders of the listed companies attempted to terminate the "war" of their own accord.

Before *Qin Li v. Chengdu Road and Bridge Engineering Co., Ltd.*[14] ("the *Chengdu Road and Bridge* case"), when the company found that Qin Li, who also received a warning and rectification decisions from the CSRC Sichuan branch,[15] had failed to disclose and suspend the purchase of shares when his shareholding reached 5%, the board of directors promptly passed a resolution on 11 March 2016, which banned Qin Li from exercising his voting rights.[16] Qin Li's interim proposal was also rejected by the board of directors on 2 March 2016.[17] However, rather than directly challenge the power of the board of directors, in the *Chengdu Road and Bridge* case, Qin Li went on to question the validity of resolutions of shareholders meetings made thereafter.[18] He also smartly asked the court to adopt a preliminary injunction, halting the enforcement of resolutions of shareholders meetings and halting the

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injunction upon one party's application with certain security provided, prohibiting another party from performing such behavior.

[12] See Announcement of Tibet Tourism on 14 October 2015, available in Chinese at <http://www.cninfo.com.cn/finalpage/2015-10-15/1201694444.PDF> (last visited 16 January 2018) and Announcement of Tibet Tourism on 15 October 2015, available in Chinese at <http://www.cninfo.com.cn/finalpage/2015-10-15/1201697513.PDF> (last visited 16 January 2018).

[13] See Announcement of Tibet Tourism on 14 June 2016, available in Chinese at <http://www.cninfo.com.cn/finalpage/2016-06-15/1202368914.PDF> (last visited 16 January 2018).

[14] Stock code: 002628.

[15] See Announcement of Chengdu Road and Bridge Engineering Co., Ltd. ("Chengdu Road and Bridge") on 16 March 2016, available in Chinese at <http://www.cninfo.com.cn/finalpage/2016-03-17/1202051425.PDF> (last visited 16 January 2018).

[16] See Announcement of Chengdu Road and Bridge on 11 March 2016, available in Chinese at <http://www.cninfo.com.cn/finalpage/2016-03-12/1202041020.PDF> (last visited 16 January 2018).

[17] See Announcement of Chengdu Road and Bridge on 2 March 2016, available in Chinese at <http://www.cninfo.com.cn/finalpage/2016-03-03/1202018689.PDF> (last visited 16 January 2018).

[18] See Announcement of Chengdu Road and Bridge on 7 September 2017, available in Chinese at <http://www.cninfo.com.cn/finalpage/2017-09-08/1203956489.PDF> (last visited 16 January 2018).

convening of future shareholders meetings before the ruling.[19] In the first trial judgment, the court supported Qin Li's claims.[20] But this "story" remained unfinished because of the company's appeal[21] and another suit initiated by the company's controlling shareholder against Qin Li, asking the court to derecognize Qin Li's shareholder identity.[22] Both cases are still pending and have no clear outcomes for the time being.

Most intriguingly, the approaches taken by both parties concerning *Kingkey Group Co., Ltd. et al. v. Shenzhen Kondarl (Group) Co., Ltd.*[23] ("the *Kondarl* case") are all-inclusive. Similarly to the *Chengdu Road and Bridge* case, the "rule breakers" were initially deprived of their shareholder's rights through a resolution of the board of directors on 1 December 2015.[24] The resolution even planned to force them to sell their shares in excess of 5%. Nevertheless, one man's meat is another man's poison. This sound solution for the original management was soon challenged by the restrained shareholders in the *Kondarl* case. The first trial court held that the resolutions of the board of directors were invalid.[25] This result was upheld by Shenzhen Intermediate People's Court in the final trial on 8 December 2016,[26] and by Guangdong High People's Court in the retrial examination on 13 April 2017.[27]

However, in reality, the above judgment and adjudications alone did not interfere with the listed company to leave the "raiders" out in the cold. At the 2015 to 2016 annual meetings of shareholders, Kingkey Group Co., Ltd. was restricted from exercising its shareholder's rights by the company. Inevitably,

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[19] See Announcement of Chengdu Road and Bridge on 26 January 2017, available in Chinese at <http://www.cninfo.com.cn/finalpage/2017-02-03/1203059228.PDF> (last visited 16 January 2018) and Announcement of Chengdu Road and Bridge on 21 February 2017, available in Chinese at <http://www.cninfo.com.cn/finalpage/2017-02-22/1203097504.PDF> (last visited 16 January 2018).

[20] See *supra* note 18.

[21] See Announcement of Chengdu Road and Bridge on 6 November 2017, available in Chinese at <http://www.cninfo.com.cn/finalpage/2017-11-07/1204114293.PDF> (last visited 16 January 2018).

[22] See Announcement of Chengdu Road and Bridge on 5 September 2017, available in Chinese at <http://www.cninfo.com.cn/finalpage/2017-09-06/1203938027.PDF> (last visited 16 January 2018).

[23] Stock code: 000048.

[24] See Announcement of Shenzhen Kondarl (Group) Co., Ltd. ("Kondarl") on 1 December 2015, available in Chinese at <http://www.cninfo.com.cn/finalpage/2015-12-01/1201799294.PDF> (last visited 16 January 2018).

[25] See Announcement of Kondarl on 21 June 2016, available in Chinese at <http://www.cninfo.com.cn/finalpage/2016-06-22/1202380363.PDF> (last visited 16 January 2018).

[26] See Announcement of Kondarl on 12 December 2016, available in Chinese at <http://www.cninfo.com.cn/finalpage/2016-12-13/1202870921.PDF> (last visited 16 January 2018).

[27] See Announcement of Kondarl on 17 April 2017, available in Chinese at <http://www.cninfo.com.cn/finalpage/2017-04-18/1203312801.PDF> (last visited 16 January 2018).

given the situation, Kingkey Group Co., Ltd. launched several other suits[28] and a preliminary injunction to halt the enforcement of resolutions of the 2016 annual shareholders meetings.[29] Beyond these actions, as of 8 January 2018, there had been around ten relevant disputes (including both concluded and pending ones) between the parties that were, to a certain extent, correlated with the original disclosure non-compliance.

III. Remedies for the Aggrieved: Discussions and Potential Solutions for China

1. Discussions: To Remedy or Not?

From observation of the cases, mere administrative penalties not only have little deterrent effect, but also offer scarcely any remedies for the aggrieved, who range from the affected listed company to its original controlling shareholder to the cheated public shareholders.

Some propose that severe punishment (and, on the other side, greater remedies) should not be imposed on the rule breakers, especially in the "takeover battle."[30] They explain that securities regulations in the United States have similar disclosure rules, i.e. Sec. 13(d) of the Securities Exchange Act of 1934,[31] and the same circumstance used to occur in its jurisdiction. But hardly any rigorous measures were taken by the U.S. Securities and Exchange Commission (SEC) against "rule breakers."[32] Furthermore, in private rights

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[28] See Announcement of Kondarl on 5 April 2017, available in Chinese at <http://www.cninfo.com.cn/finalpage/2017-04-06/1203253293.PDF> (last visited 16 January 2018).

[29] See Announcement of Kondarl on 5 September 2017, available in Chinese at <http://www.cninfo.com.cn/finalpage/2017-09-06/1203938507.PDF> (last visited 16 January 2018).

[30] See W. Zhang, Law of Capital (China Legal Publishing House 2017) 323–328.

[31] See Securities Exchange Act of 1934, available at <http://legcounsel.house.gov/Comps/Securities%20Exchange%20Act%20Of%201934.pdf> (last visited 16 January 2018).

[32] In the hedge fund Perry Corp.'s acquisition of Mylan Laboratories Inc.'s stock, although the SEC found that Perry Corp. had breached the disclosure rules of 13(d), it only fined Perry Corp. 150,000 US-Dollars, when actually the stock bought by Perry Corp. was worth around 500 million US-Dollars. See *re Perry Corp.,* Admin. Proc. File No. 3-13561 (21 July 2009), available at <http://www.sec.gov/litigation/admin/2009/34-60351.pdf> (last visited 16 January 2018).

Moreover, in Shuipan Lin's acquisition of Exceed Company Ltd.'s stock, the SEC only fined Shuipan Lin 30,000 US-Dollars. Shuipan Lin did not file his initial Schedule 13D until 19 months after he had incurred a reporting obligation. See *re Shuipan Lin,* Admin. Proc. File No. 3-16435 (13 March 2015), available at <https://www.sec.gov/litigation/admin/2015/34-74497.pdf> (last visited 16 January 2018).

of action,[33] the U.S. courts have been taking a conservative approach since 1975. The U.S. courts have also consistently held that no civil compensation should be paid to the aggrieved, whatever the company or the shareholders.[34]

The rationale behind this standpoint is that actions taken by shareholders of substantial holdings are beneficial to market competition. Just like with the Saturday Night Special, the rule breakers or "raiders" will also motivate the management to manage and develop the company better. Otherwise, they may stagnate. But severe punishments of the rule breakers or "raiders," such as forbidding them to exercise their shareholder's rights or forcing them to sell the shares, are indeed "poisons" to them. Therefore, they contend that in China, the rules of disclosure and the consequences of violations shall not impede these sorts of takeover activities.

These arguments and conclusions might sound plausible in the United States. However, they might not be well suited to China. In the United States, "takeover battles" are quite common. Most of the listed companies have armed themselves to the teeth against potential "raiders" since the advent of "poison pill." In China, however, anti-takeover measures are still uncommon, and their validity remains to be tested in future disputes and practice.

When the "raiders" break the basic market rules and arrive without any notice, both the listed company and the controlling shareholder usually have nothing at hand. All they can do is to take revenge on the "raiders" outrageously in every possible way, which can only cause endless chaos. The situation regarding the *Kondarl* case substantiates this well. Within three years, there were around ten disputes between the company, the original controlling shareholder and the "raiders." So far, no one has truly won the "battle." The "raiders" have held large quantities of shares but have no real shareholder's rights. On the other side, the disputes were detrimental to the company as well. According to the management of Kondarl, this situation has had a strong negative impact on the company's business, its source of stable clients, and its financial results, as well as the company's rating, and even got the company trapped in a financing predicament.[35]

By this token, in order to maintain the fundamental rules of the game, providing appropriate remedies to the aggrieved and punishing the "rule breakers" in statutory law to a certain extent is indispensable. In this way, the market order can be maintained, and the interest of the investing public can be protected.

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[33] In *Rondeau v. Mosinee Paper Corp.,* 422 U.S. 49 (1975), the court held that there is no basis for injunctive relief and reversed the judgment of the Court of Appeals.

[34] See ZHANG, *supra* note 30.

[35] See the news report, available at <http://www.cs.com.cn/ssgs/gsxw/201706/t20170629_5349203.html> (last visited 16 January 2018).

2. Potential Solution

Previously mentioned cases in China have provided some possible solutions worth considering in terms of remedies for the aggrieved who have suffered from the breach of conduct.

But before considering legislation or other solutions, one thing is certain: that the remedies are supposed to be sought through public power, namely, through administrative authority or the courts. Instead, the board of directors, under current law, has no power or rights to deprive the "raiders" of shareholder's rights merely through a board resolution. The judgments of the *Chengdu Road and Bridge* case and the *Kondarl* case have also shown this consensus in judicial practice.

Apart from that, prior to the establishment of any new rules, CSRC has been striving to fill the gap by interpreting and applying the current rules differently. In some administrative penalties,[36] CSRC is inclined to consider that such conduct is a breach of both Arts. 86 and 38[37] of the Securities Law. Therefore, the administrative punishments in both Arts. 193 and 204[38] would apply. This approach can magnify the penalty amount several times. Unfortunately, however, compared to the violator's gain, the magnified fines still seem to be trivial and trifling. This means that the approach of higher fines has thus far been unable to hold back the gambling impulses of the violators.

Then, what about criminal liability to curb the rule breakers? Japan has stipulated in Art. 197-2 of its Financial Instruments and Exchange Act that a person who fails to fulfill their obligation of disclosure of substantial holdings is to be punished by imprisonment for not more than five years and/or by a fine of not more than 5 million Yen.[39] However, given the restraining prin-

[36] See CSRC's administrative penalty decision regarding Wenqing Lin on 2 August 2011, available in Chinese at <http://www.csrc.gov.cn/pub/zjhpublic/G00306212/201109/t20110908_199569.htm> (last visited 17 January 2018) and CSRC's administrative penalty decision regarding Lingbin Yuan and Jun Li on 15 March 2016, available in Chinese at <http://www.csrc.gov.cn/pub/zjhpublic/G00306212/201603/t20160325_294696.htm> (last visited 17 January 2018).

[37] Art. 38 of the Securities Law stipulates that any legally issued stock, corporate bonds or any other securities, where there are any restrictive provisions on the term of their transfer, shall not be purchased or sold within the restricted term.

[38] According to Art. 204 of Securities Law, where anyone violates the relevant laws by purchasing or selling any securities during a period when the transfer of such securities is prohibited, he shall be ordered to correct this, given a warning and fined no more than the equivalent value of the securities as traded. The person-in-charge and any other person held to be directly responsible shall be given a warning and fined between 30,000 and 300,000 Yuan.

[39] See Art. 197-2 of the Financial Instruments and Exchange Act (the revisions of Act No. 99 of 2007, which took effect on 1 April 2008), available in English at <http://www.fsa.go.jp/common/law/fie01.pdf > (last visited 16 January 2018).

ciple of the criminal law and the difficulty of revising it, it is difficult for China to realize this in the short term. According to the existing rules, unless there is evidence that the shareholders are involved in insider trading, criminal liabilities may only be regarded as a vague deterrent.

Certainly, civil responsibility is not supposed to be absent. The core of commercial transactions and disputes is nothing more than interest and benefit. In the *Xinmei* case, the plaintiff was the original controlling shareholder of the listed company and did not get relief through the civil litigation. But if the plaintiff were instead the listed company or the small and medium investors, the case might turn out differently. After all, the disclosure of substantial holdings is a major issue in the securities market, as it often becomes the key piece of information for other investors in their investment decisions.

But when it comes to the specific form of remedy, for both shareholders and the listed company, seeking property damage compensation is actually not easy. It requires a great deal of argumentation and demonstration to prove the cause and degree of damage. Even in the United States, where civil litigation prevails, it is not simple to find resolution. Normally, to handle such an issue, massive data, models and expert testimony aiming to determine the amount of the loss are needed.

Perhaps because of perception of this huge injustice due to lack of practical remedies, in the first revised draft of the Securities Law, which was submitted to the Standing Committee of the National People's Congress in April 2015, Art. 126 sets forth that if investors purchase or sell the shares of the listed company over the prescribed percentage in violation of Art. 109 (similar to Art. 86 of the existing law), the securities regulatory authority under the State Council shall order them to sell or buy the shares in excess of the prescribed proportion.[40] This appears to adopt the forced sale approach claimed by the plaintiff in the *Xinmei* case.

Another approach is to restrict the exercise of shareholder's rights, which yielded widely divergent rulings in the *Xinmei* case, the *Tibet Tourism* case, and the *Kondarl* case. Obviously, this approach is controversial, but it might still be worth a shot. As a matter of fact, as analyzed in the third issue of the *Xinmei* case, this approach has to some extent already been embodied in Art. 213 of the current Securities Law, but it cannot be imposed unless the violator fails to accomplish his rectification. In the context of the disclosure obligation, it is so easy for violators to rectify that seldom would any person in these cases reject the option of doing so. That means this provision is hardly functional in the real world.

Therefore, we have to further consider the approach of temporary restrictions on the shareholder's rights even after their rectification of disclo-

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[40] See the first revised draft of the Securities Law, available in Chinese at <http://www.financialservicelaw.com.cn/article/default.asp?id=4777> (last visited 16 January 2018).

sure. It is understandable that the rights enjoyed by a civil subject is expected to be treated with caution. However, nothing is absolute and there are always exceptional rules. When the exercise or acquisition of rights is not legitimate or reasonable, such a temporary restriction on the shareholder's rights of the rule breakers is conducive to curbing "cheating takeovers". After all, the fiduciary duty of the shareholders that is required in the Securities Law is to bind all shareholders, regardless of their position. Besides this, neglecting the fundamental changes in the position of old and new controlling shareholders as a result of such a breach of disclosure rules does not seem to be fair and just. Perhaps just because of this, it is said that this restriction approach has been considered in the second revised draft of the Securities Law.[41]

And in Korea, Art. 150 of the Financial Investment Services and Capital Markets Act has taken both this approach and the aforesaid forced sale approach. Pursuant to it, a person who fails to make a report of substantial holdings is not to exercise voting rights for the shares held in violation in excess of 5% of the total number of outstanding voting shares during the time period prescribed by Presidential Decree[42], and the Financial Services Commission may issue an order to dispose of the portion held in violation within a given period of time, not exceeding six months.[43]

IV. Conclusion

At present, the liability clause is fairly weak on disclosure of substantial holdings within the overall framework of "takeover of listed companies" in China. The administrative penalties that the current Securities Law imposes on the "takeover raiders" are too light. Judicial authorities should weigh and balance cases comprehensively and thoroughly, taking actions to curb such opportunistic actions and prevent violators from easily taking enormous "rewards" from their unlawful acts, rather than further encourage them.

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[41] The second revised draft has not been fully published yet.

[42] Pursuant to Art. 158 of the Enforcement Decree of the Financial Investment Services and Capital Markets Act, where a person fails to file a required report either intentionally or by gross negligence, "the time period prescribed by Presidential Decree" begins on the date on which the relevant stocks were purchased and ends on the date on which six months have elapsed since filing the report. See Art. 158 of the Enforcement Decree of the Financial Investment Services and Capital Markets Act (amended by Presidential Decree No. 27444 on 11 August 2016, which was enforced on 12 August 2016), available in English at <http://www.law.go.kr/eng/engMain.do> (last visited 22 January 2018).

[43] See Art. 150 of the Financial Investment Services and Capital Markets Act (amended by Act No. 14242 on 29 May 2016, which was enforced on 1 December 2016), available in English at <http://www.law.go.kr/eng/engMain.do> (last visited 22 January 2018).

Contesting a listed company's controlling right has gradually become common and normal in the contemporary business field in China. Disputes and reconciliation occur constantly. There is no need to be amazed at, be hostile to or denounce those "raiders." Nevertheless, at the same time, the bottom line is to abide by the rules. Cases like the *Xinmei* case, the *Tibet Tourism* case, the *Chengdu Road and Bridge* case and the *Kondarl* case have occurred over and over again. In addition to the need for law enforcement agencies to cope with disputes, it is still necessary to close the "gap" to defend the dignity of the law. By this token, the disclosure of substantial holdings in China may seem to be sufficiently orderly already, but actually requires better regulation.

Disclosure of Substantial Shareholdings

A Korean Perspective

Sunseop Jung[*]

I. Introduction

Information about substantial shareholdings of stock-listed companies has two economic functions in capital markets.[1] Firstly, it provides information on the occurrence of massive demand for stocks, which can be used by investors to evaluate the share values of listed companies and make informed decisions. Secondly, it can make room for the management of the target companies to prepare defensive measures against hostile takeover bids.

The primary way to get such information is a shareholders' registry. Shareholders and claimants of listed companies can make a request to the compa-

[*] This paper is based on K. KIM/S. JUNG, *JaBonSiJangBob* [Capital Markets Law], (3rd ed., Du-Seong-Sa 2013) 300–334. I would like to thank Mr. Jung-soo Lee in Kim & Chang who gave comments on the draft of this paper.

[1] Financial Supervisory Service, Understanding Korea's "5% Rule", December 2005, p1("FSS(2005)").

nies to peruse the shareholders' registry (Art. 396 Commercial Code). However, the role of the shareholders' registry as a source of information is limited as the registry does not reflect the complete list of actual shareholders. There are two reasons for this. One is that the transfer of the shareholder's name is not a legal requirement for the transferee of the shares to acquire legal ownership. The transferee only needs to enter his or her name and address in the registry to exercise the shareholder's right against the company (Art. 337 para. 1 Commercial Code). The other reason is that under the book-entry system for listed companies' shares, actual shareholders' names are not entered in the registry itself. It is market practice that the name of the central securities depository is recorded in the shareholders' registry. In this case, they need to confirm a beneficial shareholders' registry prepared by the central securities depository (CSD) on behalf of the listed company (Financial Investment Services and Capital Markets Act[2], hereinafter: FSCMA, Art. 316). As a beneficial shareholders' registry is only prepared for the general meeting of shareholdings (FSCMA), Art. 315 para. 3, we cannot find subsequent changes in the composition of shareholders. On the other hand, if a company acquires more than 10% of the total number of issued and outstanding shares in another company, it is to notify the company of such acquisition without delay under the Commercial Code amended in 1995 (342-3). However, this provision is not complete in that, firstly, it does not apply to individual shareholders; secondly, it does not cover joint acquisition of shares by two or more companies; and thirdly, it cannot impose any duty to notify on a company until its possession of equity comes to 10%.

After this introduction, the second part of this paper will give an overview of the general structure of the substantial shareholdings reporting system in Korea. The third part will examine the legal issues concerning the use of total return swaps and the impact of the recently introduced Stewardship Code in the context of substantial shareholdings. The last part will summarize the discussion in this paper and provide conclusions.

II. Structure of Substantial Shareholdings Reporting

1. Overview

Korea introduced the current system for 'substantial shareholdings disclosure' in 1991 to harmonize the protection of listed companies and investor protection by amending the Securities Transaction Act (hereinafter: STA).[3] This was modelled after the US Williams Act and was intended to ensure the

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[2] Enforcement Date 4 February 2009, Act no. 8863, enacted on 29 February 2008.

[3] Enforcement Date 1 April 1962, Act no. 972, enacted on 15 January 1962.

fairness and transparency of the market for corporate control. This is generally referred to as the '5% Rule'. Before the advent of this rule, holding more than 10% of the shares of a listed company was strictly prohibited (prohibition of substantial shareholdings, STA, Art. 200).

Since its inception, the system has been strengthened in its scope of application and its content. On 1 April 1994, the STA eliminated the regulation that had restricted share ownership in a listed company to 10% (Art. 200). In place of this, the STA expanded the scope of reporting persons to include related persons. On 13 January 1997, the STA introduced penalties for violating the 5% reporting requirement. It expanded the scope of related persons and the range of securities subject to reporting requirements. It also introduced suspension of voting rights and an administrative order to dispose of equity securities in violation as penalties for violating the 5% reporting requirement (Art. 200-3 STA). On 17 January 2005, the STA was amended to require the reporting person to state whether the investment purpose was to exercise control over the management or to attain investment gains only. The 2005 amendment also provided for criminal penalties against a person who makes a false statement or falsely represents a material fact or neglects to state or represent a material fact in the 5% report (Art. 444 para. 13).

In Korea, there has been a clear increasing trend in the number of 5% reporting cases since the inception of the 5% Rule, in particular with regard to the purpose of participation in management.

Table 1: 5% Reporting (No., %)[4]

	2009		2010		2011		2012	
Participation in Management	4,898	(51.9)	4,299	(55.7)	4,110	(57.1)	3,911	(57.9)
Investment only	4,538	(48.1)	3,419	(44.3)	3,088	(42,9)	2,840	(42.1)
Domestic	8,249	(87.4)	6,938	(89.9)	6,553	(91.0)	6,197	(91.8)
Foreign	1,187	(12.6)	780	(10.1)	645	(9.0)	554	(8.2)
Total	9,436	(100.0)	7,718	(100.0)	7,198	(100.0)	6,751	(100.0)

2. *Types*

There are three types of reporting requirements in the FSCMA (Art. 147). Firstly, if a reporting person holds five percent or more of the subject securities of a listed company ("subject company"), he or she should make a Newly Acquired Securities report to the Financial Services Commission (FSC) and

[4] *Source:* Financial Supervisory Service.
Total: 2013: 7,308, 2014: 7,628, 2015: 9,025 (unofficial).

the exchange where the stocks of the stock-listed company are listed.[5] Secondly, where a reporting person changes their holdings in the subject company by one percent or more, he or she should make a Change in Holdings of Securities report. Thirdly, a person who changes the purpose of the investment in the subject company should make a Change in Investment Purpose report.

3. Reporting Person

a) Definition

A reporting person is a person who holds 5% or more of the subject securities of a listed company. In calculating the size of the subject securities held by a reporting person, the subject securities held by related parties should be added. The term "related parties" is divided into two sub-categories, "specially related persons" and "joint holders" (Art. 133 para. 3 FSCMA; Art. 141 para. 1 FSCMA Enforcement Decree). This approach is based on the presumption that related parties may exercise their voting rights in the same direction as the reporting person himself/herself does. While the concept of "specially related persons" is based on the family or organizational relationship, the term "joint holders" denotes a business relationship established by contracts or agreements between the parties involved.

b) Specially Related Persons

The term 'specially related persons' is defined in the Enforcement Decree of the Act on Corporate Governance of Financial Companies (Art. 3 para. 1). If the principal is an individual, the specially related persons include certain family members and other related corporations or organizations. If the principal is a corporation or an organization, it covers directors, affiliated companies and 30% shareholders of the corporation.

As a mutual fund takes the form of a joint stock company, it can be included in the definition of 'specially related persons' as an affiliated company if the principal holds 30% or more of shares in the fund. It should be noted that a corporation or organization in which the principal exercises *de facto* control over important matters related to the management of the corporation or organization, such as the appointment or dismissal of executive officers, can be covered by the definition of 'specially related persons.' While the definition of specially related persons has been expanded by using the concept of *de*

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[5] The FSCMA allows the establishment of securities exchanges under the requirement of the FSC permit (Art. 373-2). As a result, the substantial shareholding report should be filed to the exchange where the stocks of the relevant stock-listed company are listed. However, as there is only one securities exchange in Korea, the KRX, this paper will use the term KRX.

facto control, some commentators still note the definition's lack of clarity. In response, the regulation has created a way for directors of such a corporation or organization to be excluded from the category of 'specially related persons' if the principal's written statement of confirmation, etc., verifies that the principal does not exercise *de facto* control over the corporation or organization on important matters of the corporation or organization (Enforcement Decree of the Act on Corporate Governance of Financial Companies, Art. 3 para. 1 no. 2(d)).

The FSCMA has two more exceptions to the definition of 'specially related persons' (Art. 141 para. 3 Enforcement Decree of the FSCMA). Where it is proved that the number of stocks, etc. held by a specially related person is less than 1,000 shares or that the person does not fall under the category of joint holder, the person shall not be deemed a specially related person for the purposes of the substantial shareholdings disclosure regulation. Stock holdings of less than 1,000 shares will be viewed as being purely for investment purposes. There is a way for an exception to be recognized when a relationship is in fact not so close, even if the formal requirement is met.

c) Joint Holders

The term "joint holders" means those who have agreed to perform any of the following acts in accordance with an arrangement or an agreement with the principal (FSCMA Enforcement Decree, Art. 141 para. 2):

1. Jointly acquiring or disposing of stocks, etc.;
2. Trading stocks, etc. among each other after jointly or solely acquiring such stocks, etc.;
3. Jointly exercising voting rights (including the power to instruct others to exercise voting rights).

While 1. and 2. above are concerned with investment power on stocks, item 3. involves contracts or agreements on voting power.

How can we find the existence of contracts or agreements? It is generally argued that we do not need any proof of express agreement or contracts. Circumstantial evidence is considered sufficient.

d) Elimination of Special Relationships

There is a question of whether the decrease in holdings of securities subject to reporting due to the elimination of the special relationship is subject to the duty to report. For example, where A holds 4% of Company C's stock and B holds 3%, and A and B fall under the definition of joint holders, A and B need to report as 7% holders. If the special relationship between A and B ends after the reporting, there is a question as to whether or not the change should be reported, as the shares of 4% and 3% have changed. There has been a case which recognized the duty to report the change in the shareholding of 4% and 3%.[6]

4. Holding Interests

The FSCMA uses the term 'hold' instead of 'own.' The definition of 'hold' includes "ownership or other equivalent cases prescribed by Enforcement Decree" (Art. 133 para. 3). The Enforcement Decree of the FSCMA provides for "other equivalent cases prescribed by Enforcement Decree" as follows (Art. 142):

1. Where stocks, etc. are owned on a person's own account, regardless of in whose name they are held;
2. Where a person holds rights to claim delivery of stocks, etc. in accordance with a provision of an Act, as a result of a transaction, or under any other contract;
3. Where a person holds voting rights (including the power to instruct others to exercise voting rights) of stocks, etc. in accordance with a provision of an Act or under a money trust deed, security agreement, or any other contract;
4. Where a person holds rights to acquire or dispose of the relevant stocks, etc. under a provision of an Act or under a money trust deed, a security contract, a discretionary investment contract, or any other contract;
5. Where a person holds rights to complete a trade by unilateral reservation for trading stocks, etc. and acquires the status of purchaser by exercising such rights;
6. Where a person holds contractual rights under Article 5 para. 1 no. 2 of the Act to a contract for an underlying asset of stocks, etc. and acquires the status of purchaser by exercising such rights;
7. Where a person holds stock option and acquires the status of purchaser by exercising such option.

The FSS lists owning stocks in a borrowed name (1), having the right of a purchaser waiting for the settlement date while the contract of sale is concluded (2), holding stocks by using a specified money trust or having investment management power as an asset management company for mutual funds (3, 4), having the right to complete the reservation for the purchase (5), having call options (6), and having the right to get treasury stock or newly issued stock by exercising stock options (7) as examples of "holding interests".7

The cases listed above include not only *legal* ownership but also *de facto* ownership of stocks. They also include cases where there is only a contractual right to deliver the securities without ownership of the stock yet. They also

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[6] Seoul Central District Court, 17 March 2010, 2010KaHap521.

[7] FSS, *GiEopGongsiSilmuAnNae* [Corporate Disclosure Practice Guide], 2017, 344.

include the right to complete the reservation for the purchase even though the contract has not yet been concluded. In this regard, the court held that the investors hold the subject securities by acquiring such rights prior to the final exercise of the rights.[8] However, if the payment is made only by cash settlement, it should be interpreted as excluded from the purpose of the law. As trust contracts are included, it has become difficult to take control of companies by using specified monetary trusts as in the past. This also includes the possession of shares by private equity investment trusts. Those who have the right to acquire or dispose of the stocks, etc. under pledge contract are also considered to hold interests in such stocks.

The Supreme Court is active in acknowledging the duty to report substantial shareholdings. In a case concerning mutual credit unions, the union did not transfer the title to shares but received share certificates. All rights of shareholders, including voting rights, were exercised by the union, and the reimbursement of the loans and the ownership of the collateral shares were transferred to the union. The Supreme Court held that, in spite of the wording of the formal contract, the union had definitively acquired ownership of the stock, and even if it did not have the right to vote by the collateral contract, it held the interests of the securities.[9]

5. Holding Ratio: 5%

The duty to report substantial shareholdings occurs when more than 5% of securities subject to reporting requirements are held. In this case, the holding ratio is the ratio obtained by dividing the "number of holders' stocks" by "the total number of issued shares with voting rights of the company plus the number of shares held" (Art. 147 para. 1 FSCMA). The number of stocks held by a holder, which corresponds to the numerator when calculating the holding ratio, is the number of shares held by the holder, including the reporting person and the specially related parties. 'Stocks, etc.' include shares and bonds related to stocks held by holders. The shares with voting rights to be purchased as a result of the exercise of stock options are also included in the total number of shares held.

In the total number of issued shares corresponding to the denominator, 'issued stocks' are calculated by aggregating (1) the total number of voting stocks with voting rights and (2) the number of stocks held by holders on the day of substantial shareholding (Art. 17 para. 2 FSCMA Enforcement Decree). The reason for adding (2) to (1) is to include voting shares that are not currently issued but will be issued in the future. In order to prevent (2) from being double-counted with (1), the shares subject to exchange with exchange-

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[8] Supreme Court, 22 July 2002, 2002Do1696.

[9] *Supra* note 8.

able bonds (excluding treasury stocks), shares that constitute underlying assets of derivative-linked securities (excluding treasury stocks), and shares that underlie depository receipts held by a person and his or her specially related persons are excluded. Treasury stock is excluded because the voting right is not recognized if the issuer holds it. As a result, the "total number of issued shares, etc." will include only issued shares and stock-related bonds held by holders. The shares with voting rights to be purchased by exercising stock options, if any, are also included in the total number of issued shares, etc.

6. *Securities Subject to the 5% Report*

Securities subject to the reporting requirement are 'stocks of listed corporations.' In the case of stocks of non-listed corporations, there is no reporting requirement. It is only in the case of a stock-listed company[10] that hostile M&A can be tried without the knowledge of the current management as its stock ownership is dispersed to a certain extent. This also excludes stocks of investment companies that are unrelated to hostile M&A (see Art. 234 para. 1).

Since the reporting requirement is related to the management's right to the target company, the main securities subject to reporting are stocks with voting rights. The FSCMA provides for securities that are determined by the Enforcement Decree in addition to the stocks with voting rights as subject securities (Art. 133 para. 1). The FSCMA Enforcement Decree lists various types of potential stocks related to voting rights (Art. 139). The Enforcement Decree includes not only those issued by stock-listed companies (Type 1 securities) but also those not (Type 2 securities).

The FCSMA Enforcement Decree (Art. 139 para. 1) concerning Type 1 securities reads as follows:

"1. Securities issued by a stock-listed company, which falls under any of the following items:
  (a) Stocks;
  (b) Instruments representing preemptive rights to new stocks;
  (c) Convertible bonds;
  (d) Bonds with warrant;
  (e) Exchangeable bonds with a right to claim to exchange them with stocks under any provision of items (a) through (d);
  (f) Derivative-combined securities based on, as the underlying asset, the securities under any provision of items (a) through (e) (limited to those with rights to acquire the underlying asset by exercising such rights)."

[10] The FSCMA defines a stock-listed company as any of the following companies:
(a) A company that has issued stock certificates listed on the securities market;
(b) Where depositary receipts that are related to stock certificates are listed on the securities market, a company that has issued the stock certificates (Art. 9 para. 15 no. 3).

In relation to the stocks listed in (a) above, since they are referred to as 'voting stock' in the statute, non-voting preferred stock is excluded. There is a question as to whether preferred stock with voting rights that are revived due to the inability to pay dividends (Art. 370 para. 1 proviso Commercial Code) is included in "voting stock". It is generally agreed that it is included from the viewpoint of the purpose of the FSCMA. Item (d) does not include bond rights after the warrants are detached or exercised. The exchangeable bond of (e) above shall be limited to those that can be claimed for stocks and warrants, convertible bonds, and bonds with warrants. It does not matter whether the stock has already been issued or not. And derivatives-linked securities of (f) above include securities whose underlying assets are stocks, warrants, convertible bonds, bonds with warrants and exchangeable bonds that can be exchanged with these securities. However, it does not include derivatives-linked securities whose settlement is done by cash only and not by physical delivery of the underlying stocks or stock-related securities.

The FCSMA Enforcement Decree (Art. 139 para. 2) concerning Type 2 securities reads as follows:

"2. Securities issued by any person other than a stock-listed corporation under subparagraph 1 and falling under any of the following items:
 (a) Securities depository receipts related to securities under subparagraph 1;
 (b) Exchangeable bonds with a right to claim to exchange them with securities under subparagraph 1 or securities under item (a);
 (c) Derivative-combined securities based on, as the underlying asset, securities under subparagraph 1 or securities under item (a) or (b) (limited to those with rights to acquire the underlying asset by exercising such rights)."

In this way, the FSCMA defines the scope of securities subject to substantial shareholding very broadly, using the concept of options for voting shares. However, the use of Over the Counter (OTC) derivatives has diversified the form of holding voting rights. As the FSCMA limits the scope of securities subject to the substantial shareholding disclosure requirement to 'securities' in the Act, many types of OTC derivatives whose underlying assets are related to stocks of stock-listed companies are not included in its scope. In this regard, we can find several cases involving total return swaps and securitized derivatives in Korea.[11]

7. *Filing and Information to be Included in the Report*

a) *Filing*

In cases where both the reporting person and specially related parties hold subject securities, the person with the largest interest may make a joint filing for all the interests held by the reporting person and the specially related

[11] This issue is discussed in III.1.

parties (Art. 147 FSCMA; Art. 153 para. 4 Enforcement Decree). The FSCMA also imposes a reporting requirement on governments, local governments, and government funds that were exempted from those requirements before the FSCMA (Art. 147 para. 1 FSCMA); Art. 154 para. 2 Enforcement Decree).

A reporting person is to file the substantial shareholding report with the FSC and the Korea Exchange (KRX) (Art. 147 para. 1 FSCMA). The FSC and the KRX are to keep the reports filed for three years, and are also to disclose them through their websites, etc. (Art. 149 FSCMA).

b) Sending the Report to the Issuer

Before the FSCMA, there was no requirement of direct notification of the substantial shareholding report to the target company, unlike the notice obligations at the time of acquisition of shares exceeding 10% under the Commercial Code (Art. 342-3). However, the FSCMA requires the reporting person to send the substantial shareholding report to the stock issuers without delay (Art. 148). If a copy is not sent or a false copy is sent, a fine of up to 50 million Won may be imposed (Art. 449).

Since the FSCMA stipulates that securities issued by any person other than a stock-listed company are subject securities (Type 2 securities above), there may be a question of who sends the report. The FSCMA Enforcement Decree stipulates as the sender of the disclosure report the issuer of stocks, etc. subject to exchange in cases of exchangeable bonds, the issuer of stocks, etc. which are the underlying assets of derivative-combined securities, in the case of derivative-combined securities, and the issuer of stocks, etc. which are the underlying securities, in the case of securities depository receipts (Art. 156). It is considered appropriate to use the entity with the possibility of change of control as the sender in the light of the purpose of the substantial shareholding report requirement.

c) Reporting Deadline

A reporting person must file a report with the FSC and KRX within five days of the date of the reporting event (Art. 147 para. 1 FSCMA; Art. 153 para. 1 Enforcement Decree). If there is a change of 1% or more of the total number of stocks, the report must be submitted within 5 days of that date (Art. 147 FSCMA).

The date of the reporting event for each type of event is provided for as follows:

(i) The date of listing, where stocks issued by an unlisted stock company are listed on the securities market;
(ii) The date of the merger in cases of merger by absorption, and the date of listing in cases of consolidation of companies;

(iii) The execution date of the contract, where stocks, etc. are traded on the securities market (including transactions via an alternative trading system; hereafter the same shall apply in this paragraph);
(iv) The execution date of the contract, where stocks, etc. are acquired outside the securities market;
(v) The earlier of the payment date or the date of delivery of stocks, etc. where stocks, etc. are disposed of outside the securities market;
(vi) The date immediately following a date set for payment of a stock price, where new stocks allocated through the issuance of new shares are acquired;
(vii) The execution date of the contract for borrowing stocks where stocks, etc. are borrowed, and the date of delivery of stocks, etc., where such stocks, etc. are returned;
(viii) The effective date as prescribed in the Civil Act, where a person receives stocks, etc. as a gift, and the date of delivery of stocks, etc., where a person conveys such stocks, etc. as a gift;
(ix) The date inheritance is finalized by absolute acceptance or by qualified acceptance, where there is one heir, and the date the division of property related to stocks, etc. is completed, where there are at least two heirs, if such stocks, etc. are acquired by inheritance; and
(x) The date a relevant legal act, etc. takes effect by operation of a relevant Act, such as the Civil Act and the Commercial Act, where reporting is required on any ground other than those provided in subparagraphs 1 through 9 (Art. 153 para. 3 FSCMA Enforcement Decree).

However, in cases where a reporting person is an institutional investor, including a government entity, a local government entity, or a Korean bank, the reporting requirement will be subject to a more flexible reporting deadline (Art. 154 paras. 3, 4 FSCMA Enforcement Decree).

d) Information to be Included in the Report

In relation to the contents of the report, the FSCMA delegates specific matters to the Enforcement Decree after stipulating the content of the main contracts concerning the status of holding, the purpose of holding, and the stocks held (Art. 147 para. 1). The format of the report and other details are to be stipulated by the FSS (Art. 153 para. 6). The contents of the report have been greatly strengthened to cope with the threat of hostile M&As by foreign capital.

The FSCMA provides for two types of reporting forms according to the investment purpose of the person, one for "exercising influence on the management" and the other for "investment only." The former requires more information than the latter. The former form requires the following information (Art. 147 para. 1 FSCMA; Art. 153 para. 2 Enforcement Decree):

(i) The status of the stocks he/she holds
(ii) The purpose of holding
(iii) Essential terms and conditions of the contract related to the stocks, etc. that he/she holds
(iv) The identity and background of the reporting person and specially related parties
(v) Matters concerning the issuer
(vi) The grounds for such a change
(vii) The date, price, and method of acquisition or disposition
(viii) The form of holding
(ix) The details of procurement of funds necessary for acquisition or the goods subject to the exchange (including lenders, if the funds or the goods are borrowed);

(i) The status of the stocks he/she holds means matters concerning the type of holding, including ownership and holding, and (ii) the purpose of holding refers to the question of whether the reporting person has any intention to exercise influence on the issuer's business administration (Art. 147 para. 1 FSCMA). (iii) The essential terms and conditions of the contract include collateral agreements, trust agreements, borrowing agreements, and repurchase agreements concluded in relation to the securities. The FSS considers the criteria of major contracts such as whether the contracts can cause changes in holding stocks. For example, the major contracts include a borrowing agreement, but do not include a simple custody agreement. A collateral provider is required to report with the provision of the collateral securities.

e) Holding for the Purpose of "Exercising Influence on the Management"

(1) General

In 2005, the substantial shareholdings disclosure requirement was further strengthened in order to counter the threat of foreign investors' control over domestic companies. In this regard the purpose of holding is noteworthy. This refers to whether the investor has any intention to exercise influence on the issuer's business administration (Art. 147 para. 1 FSCMA). The purpose of "exercising influence on the management" is broadly defined to include exercising *de facto* influence on the company or its executives with respect to an event falling under any of the following subparagraphs (including exercising the right under Art. 363-2 or 366 of the Commercial Code or assigning a third party to exercise such a right in accordance with the Commercial Code or any other Acts (Art. 147 para. 1 FSCMA; Art. 154 para. 1 Enforcement Decree):

(i) Appointment or dismissal of executives, or suspension of the duties of executives;

(ii) Amendments to the articles of incorporation with respect to the organization of the company, such as the board of directors;
(iii) Changes in the company's capital;
(iv) Determination of dividends of the company;
(v) Mergers, divisions, and mergers after the division of the company;
(vi) Stock exchanges or transfers;
(vii) Transfer of business in whole or transfer of an essential part specified by the FSC;
(viii) Disposal of all assets or disposal of an essential part of assets specified the FSC;
(ix) Execution of, amendment to, or termination of contracts for leasing a business in whole or delegating business management, or sharing the profits and losses with another person entirely, or any similar contract;
(x) Dissolution of the company.

The purpose of "exercising influence on the management" does not mean any fixed purpose. The court has accepted the existence of the management participation purpose where the reporting person has an intention in their mind to participate in the management of the company in the future, considering changing circumstances.[12]

This broad definition of the purpose of investment can create a hurdle to active shareholder engagement. In particular, the FSCMA has one exception on determining dividends of the company. Funds established by acts and corporations that manage and operate such funds, like the National Pension Scheme, may exercise their rights as shareholders in determining dividends of a stock-listed company (Art. 154 para. 1 (iv) proviso FSCMA Enforcement Decree).

(2) Institutional Investors and Stewardship Code

The Korean Stewardship Code, "Principles on Institutional Investors' Fiduciary Duties", was released by the Korea Stewardship Code Council led by Korea Corporate Governance Service on 16 December 2016.[13] This Code "sets forth seven detailed principles and guidelines that institutional investors holding the shares of publicly listed companies in Korea should follow to fulfill their fiduciary duties as a steward taking care of and managing the assets entrusted by others. Institutional investors should discharge their fiduciary responsibilities faithfully through the shareholder activities such as monitoring investee companies and actively engaging in a dialogue with them if a concern is identified."[14]

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[12] Seoul Administration Court, 5 September 2008, 2008GuHap23276.

[13] Korea Corporate Governance, Korea Stewardship Code: Principles on the Stewardship Responsibilities of Institutional Investors, December 2016; Korea Stewardship Code Guide Book version 1, June 2017.

As the Stewardship Code requires institutional investors' active engagement as shareholders, it can change the investment purpose of institutional investors from investment only to "exercising influence on the management". The FSC released guidelines on interpretation of the Korea Stewardship Code in the context of the substantial shareholdings disclosure requirement on 8 June 2018.[15,16]

f) Cooling-off Period

If an investor who has no intention to influence the management of a company has the purpose of participating in management, the person shall report within five days (Art. 147 para. 4 FSCMA; Art. 155 Enforcement Decree). Any person who makes such a change shall be restricted from voting rights for five days from the date on which the reason for the change is reported, and further acquisition of shares shall be prohibited (Art. 150 para. 2 FSCMA). This is referred to as the cooling-off period. The purpose of the cooling-off period is that those who acquire stocks for the purpose of corporate control should disclose the facts in advance to prevent surprise attacks on the management of the target company and to allow for the preparation of defenses for a certain period.

The FSCMA changed the date of occurrence of the cooling period, which had previously been the date of the report, to the date of reporting event. Any person who acquires additional stocks in violation of the prohibition shall be restricted from exercising voting rights on the additional acquisition, and the FSC may order the disposition of the additional acquisition within six months (Art. 150 para. 3).

8. Sanctions

a) General

When a reporting person violates the substantial shareholdings disclosure requirements by late disclosure, misrepresentation or omission of material facts in the report, the FSC may take administrative actions. Firstly, the FSC may issue an administrative order, including recommending the dismissal of executives; filing criminal complaints against the person in violation; informing a related agency or an investigative agency of violations of other Acts; or issuing warnings or cautions (Art. 151 FSCMA). Secondly, the person in violation of

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[14] Purpose of the Code <http://sc.cgs.or.kr/eng/about/sc.jsp>.

[15] FSC, Legal Interpretations on the Stewardship Code, June 2017 (in Korean). "Regulations Relaxed for More Institutional Investors to Adopt Stewardship Code", Business Korea, 9 June 2017, to be found on <http://www.businesskorea.co.kr/news/articlePrint.html?idxno=18321>.

[16] This issue is discussed in III.2.

the substantial shareholdings disclosure requirements shall be restricted from exercising voting rights for the stocks in violation and/or the FSC may issue an order to dispose of those shares within six months (Art. 150 FSCMA; Arts. 157, 158 Enforcement Decree). Of particular importance are voting rights restrictions and stock disposition. In the following, this paper focuses on limitation of the exercise of voting rights and of stock disposition.

b) Limitation of the Exercise of Voting Rights

Any person who fails to comply with the duty to report or falsely reports "important matters stipulated in the Enforcement Decree" or omits the description may not exercise their voting right to any portion in violation that exceeds 5% of the total number of outstanding voting shares for a certain period (Art. 150 para. 1). As "any portion in violation" is the subject of the disposition order described below (Art. 150 para. 3 FSCMA), its interpretation is significant.

"Important matters stipulated in the Enforcement Decree" include matters concerning a reporting person and specially related parties, the purpose of holding stocks, the class and number of stocks held or changed, the date of acquisition or disposition, and the terms and conditions of a trust contract, collateral agreement, or any other important contract for stocks held by the shareholder (Art. 157 FSCMA Enforcement Decree).

The period during which the voting right is restricted is specified in the FSCMA Enforcement Decree, according to what the case may be. Firstly, in the case of breach of the duty to report by intention or gross negligence, the restriction period is six months after the date of report (including the correction report) from the date of purchase of the stocks (Art. 158(i)). Secondly, in the case that the 5% disclosure has already been reported to the FSC and/or the KRX in accordance with laws and regulations or because of a "mistake" due to the acquisition or disposition of stocks in accordance with the approval, guidance and recommendation of the government, the exercise of voting rights is limited until the date of report (Art. 158(ii)). In this regard, two more issues need to be considered.

The first issue is the scope of the phrase "the 5% disclosure has been already reported to the FSC and/or the KRX in accordance with laws and regulations." In this case, it is necessary to interpret this wording flexibly, because it is intended to protect persons who have reported to the FSC and the KRX in accordance with other reporting requirements under laws and regulations. Laws and regulations include, *inter alia,* the FSCMA. The second issue is the scope of "the acquisition or disposition of stocks in accordance with the approval, guidance and recommendation of the government." The government's approval, guidance, and recommendation, as mentioned here, must have a legal basis – for example, FSC approval of the acquisition of other companies by financial institutions (Art. 24 Act on the Structural Improvement of the Financial Industry), or FSC approval of the acquisition of bank shares by the same person[17] (Art. 15 para. 3 Banking Act).

The effect of the restriction of voting rights occurs automatically without waiting for administrative action by the FSC. In practice, when it is unclear whether voting rights are restricted, the shareholder may seek a preliminary injunction to exercise voting rights in advance, or the company may seek a provision prohibiting voting rights.

c) Disposition Order

The FSC may issue an order to dispose of those shares in violation of the 5% disclosure requirement within six months (Art. 150 para. 1 FSCMA). Unlike the limitation of the exercise of voting rights, which is automatically effected, it is at the discretion of the FSC whether or not to issue a disposition order. It is of use to note the relationship between the limitation of voting rights and the order of disposition for violations. The question is whether it is possible to issue a disposition order for stocks that have exceeded the six-month voting rights restriction period due to breach of the 5% disclosure requirement. The court held that

"unlike the voting rights restriction which stipulates a certain period of time in the statute, in view of the fact that the stock disposition order does not have provisions to restrict the object or limit the period of exercise, the object of a stock disposition order cannot be considered to be limited to stocks whose voting rights are restricted for a period of six months."[18]

We have one more question on the scope of the disposition order: whether the stock disposition order includes prohibition of re-acquisition. There are pros and cons on this issue both in the academic sector and in FSC practices. However, it would be difficult to interpret the scope of the disposition order as including the prohibition of reacquisition.

The disposition order is a strict sanction that may have a decisive influence on the competition between the acquirer and the manager. There has been a case which approved the validity of disposition orders as a sanction for the misstatement of the investment purpose.[19]

d) Penalties

A reporting person who fails to submit the 5% disclosure report shall be subject to a maximum of three years' imprisonment or a maximum 100 million

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[17] The term "same person" in the Banking Act means the principal and a specially related person. "Same person" is the basic concept for the regulation of shareholding in banks in Korea. For more details, see S. JUNG, *EunHaenfBob* [Banking Law] (2017) 72–93.

[18] Seoul Administration Court, 9 September 2008, 2008GuHap 23276.

[19] Seoul Administration Court, 5 September 2008, 2008GuHap23276.

Korean Won fine (Art. 445(xx) FSCMA). A reporting person who makes a misrepresentation or omission of material facts in the report shall be subject to a maximum of five years' imprisonment or a maximum fine of 200 million Korean Won (Art. 444(xviii) FSCMA). A reporting person who violates the stock disposition order (Art. 150 paras. 1, 3) may be subject to a maximum of one-year imprisonment or a maximum fine of 30 million Korean won (Art. 446(xxvi) FSCMA).

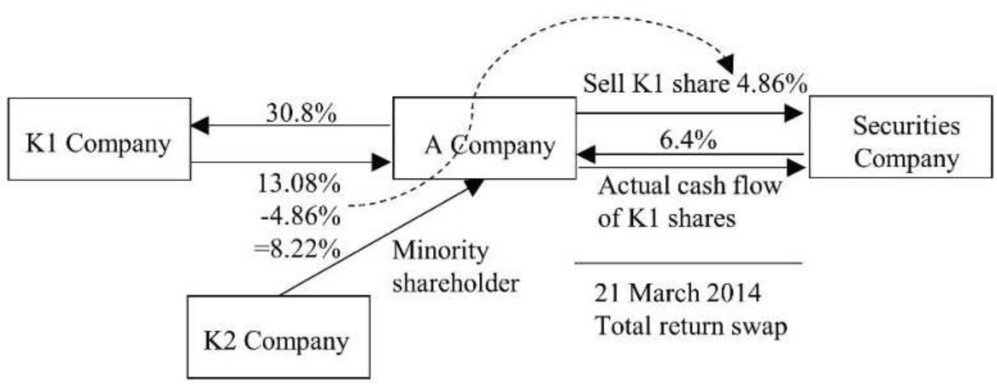
III. Substantial Shareholdings and Other Legal Issues

1. TRS

a) General

In Korea there have been several cases in which a company has used a total return swap (TRS) to evade restrictions on the exercise of voting rights. There are arguments for labelling TRS that are based on equity securities as being equity securities subject to the 5% disclosure requirement.

b) A Company Case



According to the Commercial Code, Art. 369 para. 3, in cases where a company, its parent company and its subsidiary company together hold, or its subsidiary company alone holds more than ten percent of the total issued and outstanding shares in another company, the other company shall have no voting rights for shares it holds in the company or the parent company. In this case, on 27 March 2014, the shareholders' meeting of Company A appointed the management of Company K1 as directors. Company K2 opposed this. K2 argued that because A was still holding 4.86% of K1 shares on its own account, its exercise of voting rights was in violation of the Commercial Code, Art. 369 para. 3. The issue was the impact of the TRS transaction in determining who was the holder of the 4.86% of K1 shares, which was the underlying asset of the TRS transaction. The court did not accept K2's argument.[20]

Even though the FSCMA defines the scope of securities subject to substantial shareholding very broadly, using the concept of options for voting shares, the FSCMA limits the scope of securities subject to substantial shareholding disclosure requirement to 'securities'. We need to discuss the necessity of legislative reform to include many types of OTC derivatives in which their underlying assets are related to stocks of stock-listed companies.

c) Elliot Management Case

According to news reports, Korean prosecutors will investigate the hedge fund Elliot Management, which opposed the merger between Samsung C&T and Cheil Industries.[21] Elliot Management is alleged to have violated the substantial shareholdings disclosure requirement. The issue may be whether the hedge fund secretly increased its stocks by using a TRS to hide its purchase of Samsung C&T stocks.

2. Stewardship Code

The Stewardship Code raises two legal questions. One is the application of the substantial shareholdings disclosure requirement specifically with regard to the purpose of "exercising influence on the management." The other is the application of the insider trading regulation. The FSC published its Legal Interpretation of the Stewardship Code in June 2017.

The fundamental issue is whether institutional investors participating in the stewardship code should report the purpose of their holdings as "exercising influence on the management" when reporting substantial shareholdings. In this regard, the FSC held that since the implementation of shareholder activities according to the stewardship code varies, it is not necessary to report that the stewardship code is for "exercising influence on the management."[22] However, these interpretations do not have binding force on the court as administrative interpretations. These issues still need more discussion.

3. Market Manipulation and Other Securities Fraud

There are many cases in which false statements or omitted material facts in the 5% report have been punished as market manipulation and other securities

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[20] Seoul Southern District Court 11 June 2015.

[21] "Prosecution to Look into Elliot Management for 5% Rule Violation", Business Korea, 23 February 2016, to be found on <http://www.businesskorea.co.kr/news/articleView.html?idxno=13923>.

[22] FSC, Legal Interpretation of the Stewardship Code, June 2017, 19.

fraud.[23] Active shareholder participation based on the Stewardship Code increases the likelihood of shareholders' access to companies' non-public material information. The possibility of unauthorized use of non-public material information will increase. Therefore, a safe harbor clause, which exempts the liability of shareholders who establish and operate an internal control system such as a Chinese wall system, should be reflected in the FSCMA. 5% disclosure is problematic in two aspects. Firstly 5% disclosure is used as an illegal means for market manipulation. Secondly, insider information is acquired through acquisition of more than 5% stake, which will increase the likelihood of insider trading in the future.

IV. Conclusion

The substantial shareholdings disclosure requirement is a precondition for investors' informed investment decisions in the capital market and fair competition in hostile takeover markets. The Korean system can be summarized as having the following four characteristics, which justify legislative reform for legal certainty in this area:

Firstly, Korea has expanded the coverage of the substantial shareholdings disclosure requirement by using general concepts such as "holding" or "investment purpose."

Secondly, the disposition order as a sanction against a violation of the 5% Rule may have a decisive influence on the competition between the acquirer and the manager.

Thirdly, major decisions such as the disposition order are made by the government's administrative action by the FSC, not by the court.

Fourthly, the use of OTC derivative instruments such as TRS and the application of stewardship codes present new challenges in the operation of the substantial shareholding reporting system in Korea. These new challenges also raise questions in the area of market manipulation and other securities fraud.

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[23] For example, Supreme Court, 9 February 2006, 2005Do8652; Supreme Court, 28 July 2011, 2008Do5399.

III. Takeovers in General

Selected Issues in German Takeover Law

Mandatory Bids, Minimum Pricing Rules

Dirk A. Verse

I. Introduction

1. Regulatory Framework for Public Company Takeovers in Germany

Public company takeovers in Germany are governed by the Securities Acquisition and Takeover Act (hereinafter: Takeover Act).[1] The Act entered into force in 2002 in the aftermath of the Vodafone/Mannesmann takeover.[2] It is supplemented by a number of regulations, particularly the Takeover Act Offer Regulation (Offer Regulation)[3], which contains supplementary rules on

[1] *Wertpapiererwerbs- und Übernahmegesetz,* WpÜG. An English translation of the Takeover Act and the regulations supplementing the Act is available at <www.bafin.de>.

[2] On the legislative history of the Act, see J. ADOLFF/B. MEISTER/C. RANDELL/K. D. STEPHAN, Public Company Takeovers in Germany (Munich 2002) 105–110.

[3] *WpÜG-Angebotsverordnung.*

the contents of the offer document, the pricing rules for voluntary takeover offers and mandatory offers, and the circumstances in which exemptions from the mandatory bid obligation may be granted. The 2002 Takeover Act and the supplementing regulations are the first binding takeover regulation in Germany. Prior to 2002, Germany had only a non-binding Takeover Code, first issued by the Exchange Experts' Commission at the Federal Ministry of Finance in 1995,[4] which had only limited significance in practice.

It is important to note that, as in all Member States of the European Union, Germany's takeover law is at least partly influenced by EU law, more specifically the EU Takeover Directive (TOD) of 2004.[5] The Directive contains certain core principles that Member States must implement into their domestic takeover laws. In particular, it requires all Member States to provide for a mandatory bid rule (Art. 5 TOD) and to introduce rules on board neutrality (anti-frustration, Arts. 9, 11, 12 TOD). However, the Takeover Directive provides only for a fairly modest level of harmonisation: its level of detail is low, and it provides only for minimum harmonisation (Art. 3 para. 2 TOD), so that Member States are free to introduce stricter provisions. As a result, the takeover laws in the Member States still deviate considerably from one another even in central issues like, e.g., the control threshold that triggers the mandatory bid obligation, or the pricing rules.[6] In Germany, implementing the Directive required only moderate amendments to the Takeover Act of 2002 because the Act had already been drafted with a view to the then forthcoming Directive.

2. *Scope of Application, Taxonomy*

The Takeover Act applies to public offers to acquire shares in listed companies, i.e. companies with shares admitted to trading in a regulated market in Germany. It primarily regulates offers to acquire shares in listed companies having their registered seat in Germany,[7] but in certain circumstances it is

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[4] *Übernahmekodex der Börsensachverständigenkommission*. For details, see T. PÖTZSCH, in: Assmann/Pötzsch/Schneider (eds.), Wertpapiererwerbs- und Übernahmegesetz (Cologne 2002) Introduction, paras. 19–23.

[5] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids. For a general introduction, see e.g. M. LUTTER/ M. BAYER/ J. SCHMIDT, Europäisches Unternehmens- und Kapitalmarktrecht (6th ed., Berlin 2018) § 28; S. GRUNDMANN, European Company Law (2nd ed., Cambridge 2012) § 30; M. HABERSACK/ D. A. VERSE, Europäisches Gesellschaftsrecht (5th ed., Munich 2019) § 11.

[6] For a detailed assessment, see the comprehensive study by MARCCUS PARTNERS, The Takeover Bids Directive, Assessment Report, 2012. This study was commissioned by the European Commission and is available at <www.publications.europa.eu/en/publication-detail/-/publication/67501b75-7583-4b0d-a551-33051d8e27c1>.

[7] Currently, there are more than 500 companies falling into this category; cf. W. BAYER/T. HOFFMANN, Aktienrecht in Zahlen II (Jena 2015) 7: 534 as per 1 July 2014.

also applicable to foreign companies listed in Germany but registered in another Member State of the EU or the European Economic Area (EEA).[8]

There are four different categories of public offers regulated by the Act: two types of voluntary bids and two types of mandatory bids. The most frequent type is the *takeover bid* ("Übernahmeangebot"), a voluntary offer aimed at gaining control over the target company, with control being defined as the holding of at least 30% of the voting rights.[9] If a voluntary bid is not aimed at gaining control, it is referred to as a *simple acquisition bid* ("einfaches Erwerbsangebot"). This category encompasses cases where the bidder only seeks to acquire a maximum of up to 29.9% of the voting shares, or where the bidder already holds a controlling stake above the 30% threshold and wishes to acquire further shares. The distinction between these two types of voluntary offers is important because takeover bids are subject to a much tighter regulation than simple bids. In particular, takeover bids must always be full bids, which means that they must address all shareholders for all of the shares in the target company,[10] and they must comply with certain minimum pricing rules.[11]

The third type of bid is the *mandatory bid,* which is triggered by a change of control. If someone acquires control in any other way than by way of a takeover bid, he/she is obliged to launch an offer to all remaining shareholders at a certain minimum price.[12] Finally, since November 2015, a fourth category of offers is also governed by the Takeover Act: the *delisting mandatory bid* (or delisting bid). If a company applies to the stock exchange to have its shares delisted from the regulated market, the Stock Exchange Act now requires the company or a third party, usually its principal shareholder, to launch an offer to all other shareholders in accordance with the provisions of the Takeover Act, again subject to certain minimum pricing rules (which, however, partly deviate from the pricing rules for takeover bids and mandatory bids discussed below).[13] The delisting bid may be combined with a takeover bid or a mandatory bid in one single offer document.[14]

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[8] See §§ 1 para. 3, 2 para. 3 no. 2 Takeover Act.

[9] § 29 Takeover Act.

[10] § 32 Takeover Act.

[11] § 31 Takeover Act, §§ 3–7 Offer Regulation. On the pricing rules, see *infra* at III.

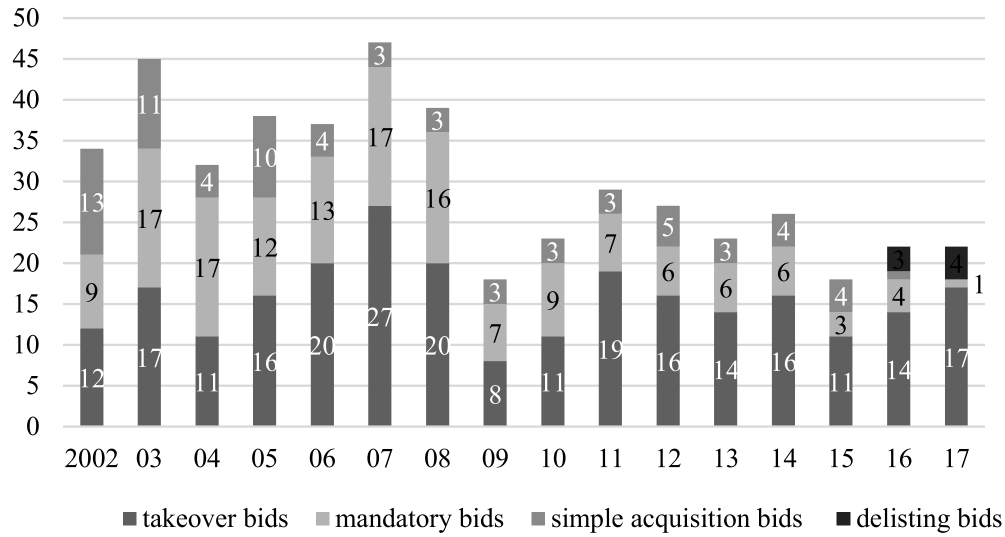
[12] § 35 Takeover Act. For details see *infra* at II.

[13] § 39 para. 2 sent. 3 no. 1, para. 3, para. 4 Stock Exchange Act *(Börsengesetz).* For a closer analysis of the new provisions on delisting mandatory bids, see, e.g., R. Harnos, Aktionärsschutz beim Delisting, Zeitschrift für das gesamte Handels- und Wirtschaftsrecht 179 (2015), 750; D. Kocher/E. Seiz, Das neue Delisting nach § 39 Abs. 2–6 BörsG, Der Betrieb 2016, 153; D. A. Verse, Aktionärsschutz beim Delisting – Reform und Reformperspektiven, in: Siekmann et al. (eds.), Festschrift für Theodor Baums (Tübingen 2017) 1317; C. Sanders, Anlegerschutz bei Delisting zwischen Kapitalmarkt- und Gesellschaftsrecht (Berlin 2017) 80–148.

[14] BaFin (Federal Financial Supervisory Authority), annual report 2016, 190–191.

3. Empirical Data

The number of bids conducted under the German Takeover Act since 2002 is shown in the table below:[15]



Number of bids under the Takeover Act 2002–2017

While in the first years of the Takeover Act the number of mandatory bids was not much lower (and sometimes even higher) than the number of takeover bids, the picture has since changed. Mandatory bids are now clearly less frequent than takeover bids. Even in cases where the bidder acquires a controlling stake by way of a negotiated block transaction outside the offer, the takeover is nowadays often structured so that a takeover bid is launched instead of a mandatory bid.[16] The reason behind this is not the pricing of the offer, because takeover bids and mandatory bids are subject to the same pricing rules under German law. Rather the reason appears to be that bidders believe the target's shareholders will react more open to a voluntary offer than to a compulsory one.

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[15] The data is based on BaFin's annual reports 2002–2017 (<www.bafin.de>).

[16] It is not difficult to structure the transaction in a way that evades the mandatory bid in favor of a takeover bid. All that is required is that the bidder publishes his intention to launch a takeover bid (§ 10 Takeover Act) before he acquires control. The German Supervisory Authority (BaFin) will then continue to treat the offer as a voluntary takeover offer, even if the bidder has in the meantime acquired control outside the bid before the end of the offer period; see KRAUSE/PÖTZSCH, in: Assmann/Pötzsch/Schneider, *supra* note 4, § 35 no. 275.

4. *Key Objectives of the Takeover Act*

The key objectives of the German Takeover Act are very similar to the takeover laws of most other jurisdictions:[17]

– The Act seeks to provide a reliable procedural framework for conducting public bids in a predictable and speedy procedure.
– It aims to establish a high level of transparency, especially for the target's shareholders and employees, by imposing various disclosure and reporting obligations mainly for the bidder[18], but also for the management board and the supervisory board of the target company[19].
– Last but not least, the Act seeks to ensure fair and equal treatment of the target's shareholders, in particular through the mandatory bid rule and the pricing rules for takeover bids and mandatory bids.

In the following, I would like to focus on the latter aspect: the protection of shareholders through the mandatory bid and the minimum pricing rules. Of course, there are further important issues that deserve mention, especially the anti-frustration rules, but they are dealt with in another contribution to this volume.[20]

II. The Mandatory Bid Rule (MBR)

1. *Contents of the MBR*

The basic contents of the German MBR is simple: if someone reaches or surpasses the control threshold (30% of the voting rights) in a listed company in any way other than through a takeover bid, this new controlling shareholder is obliged to (i) disclose the acquisition of control without undue delay, and (ii) launch an offer to all remaining shareholders of the target company.[21] The offer must be made at a fair price, which means that it must comply with two minimum pricing rules:[22] Firstly, the offer price must be no less than the highest price that the bidder paid or agreed to pay for shares in the target in

[17] For more details on the Act's objectives, see the explanatory notes of the German government on the introduction of the Takeover Act, Bundestags-Drucksache (German Parliament document) 14/7034, 28.

[18] §§ 10, 11, 23 Takeover Act.

[19] § 27 Takeover Act.

[20] See the speech on „Pre- and post-bid defences" given by *Mülbert* at the 2017 Seoul Conference.

[21] § 35 Takeover Act. The offer document must be submitted for approval to the Supervisory Authority (BaFin) within four weeks after the announcement of the acquisition of control, § 35 para. 2 sent. 1 Takeover Act.

[22] §§ 4, 5 Offer Regulation (in conjunction with §§ 39, 31 Takeover Act).

the six-month period before the offer (the "highest price rule"). And secondly, the offer price must not fall short of the average stock market price of the target shares in the three-month period before the announcement of the acquisition of control (the "stock market price rule"). We will revisit the details of this price regime below.[23]

2. *Rationale and Justification of the MBR*

The primary rationale behind the MBR is what may be described as the "exit rationale".[24] When a company becomes subject to the influence of a controlling shareholder, there is a concern that the dominant influence might be used to the disadvantage of the company, for example through non-market price transactions (tunneling) or by preventing the company from expanding into business areas covered by another entity controlled by the same controlling shareholder. Of course, minority shareholders already enjoy protection against such exploitation under company law – and in Germany under the law of corporate groups *(Konzernrecht)* in particular – but there is always a risk that this protection works only imperfectly. What is more, a change of control will often have far-reaching consequences for the strategy and business policy of the company.[25] It is therefore fair to say that it affects the basis of the investment decision originally made by the target company's shareholders.[26] For these reasons, the MBR grants minority shareholders an option to exit the company at a fair price.

A second rationale underlying the MBR may be referred to as the "control premium rationale" or "equal treatment rationale".[27] Together with the highest price rule, the MBR seeks to ensure that, if the acquirer paid a premium for acquiring control, the same control premium is offered also to all other shareholders. This notion of equal treatment is based on the old but controversial idea that the power going with control is a "corporate asset" which belongs to all shareholders equally.[28]

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[23] *Infra* at III.

[24] EUROPEAN COMPANY LAW EXPERTS (ECLE), Response to the European Commission's Report on the Application of the Takeover Bids Directive, November 2013 (<www.ssrn.com>) 2; for a more detailed discussion, see D. KERSHAW, Principles of Takeover Regulation (Oxford 2016) 8.28–8.32.

[25] This aspect is stressed in the explanatory notes of the German government on the introduction of the Takeover Act, Bundestags-Drucksache (German Parliament document) 14/7034, 27.

[26] D. KLEINDIECK, Funktion und Geltungsanspruch des Pflichtangebots nach dem WpÜG, Zeitschrift für Unternehmens- und Gesellschaftsrecht 2002, 546, 558–559; H. FLEISCHER, Schnittmengen des WpÜG mit benachbarten Rechtsmaterien – eine Problemskizze, Neue Zeitschrift für Gesellschaftsrecht 2002, 545, 548.

[27] ECLE, *supra* note 24; KERSHAW, *supra* note 24, 8.33–8.34.

[28] The classic statement of this argument is by A. A. BERLE/G. C. MEANS, Modern Corporation and Private Property (New Brunswick 1932) 244 ("the power going with

Taken together, both rationales ultimately serve the same overarching objective, namely to foster investor protection and investor confidence, and to enhance the attractiveness of investments in shares of listed companies as a minority shareholder.[29] On the other hand, there is no denying the fact that the mandatory bid renders takeovers much more costly for the acquirer and thus poses an obstacle also for value-enhancing takeovers. For this reason, the economic assessment of the MBR has always been, and still is, controversial.[30] In fact, there was a long period during which the German government strongly opposed introducing the MBR into the European Takeover Directive, before it finally decided to support European adoption of the rule[31]. Nowadays, however, there is wide support for the MBR among the stakeholders both in the EU and in Germany. An external study commissioned by the EU Commission in 2012 revealed that 90% of the respondents across the EU regard the MBR as helpful,[32] and another study showed that a majority of the respondents in Germany were even in favour of tightening and expanding the reach of the MBR (in order to prevent so-called "lowball offers").[33] However, given that the economic efficiency of the rule is still uncertain, there is also some support for the view that the rule should be amended so that companies are granted the possibility to opt-out of the MBR through an amendment to the company's constitution.[34]

'control' is an asset which belongs only to the corporation"). For a critical view, see, e.g., recently M. HABERSACK, Non-frustration Rule and Mandatory Bid Rule – Cornerstones of European Takeover Law?, European Company and Financial Law Review 2018, 1, 31–32.

[29] K. J. HOPT, European Takeover Reform of 2012/2013 – Time to Re-examine the Mandatory Bid, European Business Organization Law Review 15 (2014), 143, 171; FLEISCHER, *supra* note 26, 548.

[30] For a discussion of the pros and cons, see, e.g., H. FLEISCHER/E. BUEREN, in: Paschos/Fleischer (eds.), Handbuch Übernahmerecht nach dem WpÜG (Munich 2017) § 3 paras. 113–115; HOPT, *supra* note 29, 167–172; E. P. SCHUSTER The Mandatory Bid Rule: Efficient, After All?, The Modern Law Review 76 (2013), 529. For further references, see *infra* note 34.

[31] See KRAUSE/PÖTZSCH, in: Assmann/Pötzsch/Schneider, *supra* note 4, § 35 para. 18, 42.

[32] MARCCUS PARTNERS, *supra* note 6, 117.

[33] C. H. SEIBT, Reform der EU-Übernahmerichtlinie und des deutschen Übernahmerechts, Ergebnisse einer Experten-Umfrage, Zeitschrift für Wirtschaftsrecht, 2012, 1, 7: 60%. On the low-balling issue, see *infra* at III.3.

[34] L. ENRIQUES/R. J. GILSON/A. M. PACCES, The Case for an Unbiased Takeover Law (with an Application to the European Union), Harvard Business Law Review 4 (2014), 85; HABERSACK, *supra* note 28, 32–36; KERSHAW, *supra* note 24, 8.42–8.45. Note that this opt-out approach has been adopted in Switzerland, which is not an EU member state and therefore not bound by the requirements of the TOD; Art. 125 paras. 3, 4 Swiss Act on Financial Markets Infrastructure (*Finanzmarktinfrastrukturgesetz,* FinfraG); but see also HOPT, *supra* note 29, 174–176.

3. *Trigger for the MBR*

As mentioned before, the (only) threshold that triggers the mandatory bid obligation in Germany is at 30% of the voting rights.[35] The idea behind the 30% threshold, which is inspired by the UK Takeover Code and is also used in many other EU member states,[36] is that the attendance rates at the general meetings of listed companies are usually lower than 60% so that, typically, a 30% shareholder controls the majority of the votes represented in the general meeting. It is obvious that this threshold is a very formal trigger, given that it applies regardless of the actual attendance rates in the respective company. As a result, a shareholder holding 29.9% of the voting rights will never be obliged to launch a mandatory bid, even if he/she regularly holds the majority of the votes represented in the general meeting. The purpose underlying this formal approach is to provide for a high degree of legal certainty.[37]

However, it is sometimes difficult to determine for a potential bidder whether he/she has actually reached the 30% threshold. The reason for this is that the voting rights held by a shareholder must be aggregated with any voting rights held by related third parties, such as subsidiaries, trustees or concert parties, because their shares are attributed to the shareholder.[38] The relevant aggregation rules are sometimes difficult to apply in practice, so that the desired goal of legal clarity and certainty is far from always achieved.

4. *Exemptions*

In certain situations defined in the Takeover Act and the Offer Regulation, the acquirer of a controlling position may apply to Germany's supervisory authority (the Federal Financial Supervisory Authority, referred to as "BaFin") for an exemption from the mandatory bid.[39] Such exemptions play an important role in practice. In fact, the number of exemptions is much higher in Germany than the number of mandatory bids.40

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[35] §§ 29 para. 2, 35, 39 Takeover Act.

[36] Note that Art. 5 para. 3 TOD leaves it to the Member States to determine the percentage of voting rights which confers control. For a comparative overview across the EU, see MARCCUS PARTNERS, *supra* note 6, 126–130.

[37] For a discussion of the merits of the formal approach and potential alternatives, see A. CAHN, Der Kontrollbegriff des WpÜG, in: Mülbert/Kiem/Wittig (eds.), 10 Jahre WpÜG (Frankfurt/Main 2011) 77; HOPT, *supra* note 29, 173–174.

[38] § 30 Takeover Act. On the concept of acting in concert in § 30 para. 2 Takeover Act, see D. A. VERSE, Acting in Concert in German Company and Takeover Law, in: Fleischer/Hansen/Ringe (eds.), German and Nordic Perspectives on Company Law and Capital Markets Law (Tübingen 2015), 215; for a recent judgment on the same concept under the Securities Trading Act (*Wertpapierhandelsgesetz,* WpHG), see BGH, 25 September 2018, II ZR 190/17, Neue Zeitschrift für Gesellschaftsrecht 2018, 1350.

[39] See § 36 Takeover Act, and § 37 Takeover Act in conjunction with § 9 Offer Regulation.

The most frequent example where BaFin grants an exemption is where the controlling position in the target is transferred within the same corporate group, i.e. from one affiliate to another.[41] In this case, there formally is a new controlling shareholder, but the ultimate controlling shareholder is still the same parent company of the same corporate group. The minority shareholders' interests are therefore not materially affected, and hence the exit rationale of the MBR does not apply.

There are several further situations where an exemption can be granted, for example in the case of inheritance or gifts,[42] or in cases where the target company is in financial distress and the takeover is considered helpful for the rehabilitation of the company.[43] Also, a shareholder who holds 30% or more of the voting rights but cannot exert real dominating influence over the company will be exempt, especially when there is another shareholder holding more voting rights.[44] However, unlike the UK Takeover Code, German law does not provide for the possibility of dispensing with mandatory bid obligations in cases where the independent shareholders approve of the dispensation by ordinary resolution ("whitewash" resolution).[45]

5. *Enforcement*

When the new controlling shareholder has not obtained an exemption and is thus obliged to launch a mandatory bid, but does not do so, the issue of enforcement arises. Primarily, it is up to the competent authority (BaFin) to ensure that the MBR is complied with accurately. BaFin is entitled to issue orders to launch a mandatory bid,[46] and it is also entitled to impose fines

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[40] From 2002 to 2017, 150 mandatory offers were made in Germany, while more than 900 exemptions were granted by BaFin. The number of bids and exemptions in each year is published in BaFin's annual reports (*supra* note 15).

[41] § 36 no. 3 Takeover Act.

[42] § 36 no. 1 Takeover Act (inheritance and gifts among family members); § 9 sent. 1 nos. 1–2 Offer Regulation (inheritance and gifts among non-family members).

[43] § 9 sent. 1 no. 3 Offer Regulation.

[44] § 9 sent. 2 no. 1 Offer Regulation. In this scenario, BaFin will usually grant the exemption subject to the condition that the other shareholder does not sell his/her shares; see KRAUSE/PÖTZSCH/SEILER, in: Assmann/Pötzsch/Schneider, *supra* note 4, § 9 WpÜG-AngVO para. 64.

[45] For the position under UK law, see UK Takeover Code, Notes on Dispensations from Rule 9, no. 1; KERSHAW, *supra* note 24, 8.25. Note that the whitewash procedure in the UK is available only in limited circumstances (especially where the crossing of the control threshold results from the issue of new shares by the target company).

[46] This can be deducted from § 4 para. 1 sent. 3 Takeover Act; see OLG Frankfurt am Main, 5 December 2011, WpÜG 1/11, Neue Zeitschrift für Gesellschaftsrecht 2012, 302, 304; KRAUSE/PÖTZSCH, in: Assmann/Pötzsch/Schneider, *supra* note 4, § 35 no. 248.

(payable to the State, not to the target company shareholders) in cases of intentional or grossly negligent breaches of the MBR.[47]

However, there may be cases where BaFin mistakenly takes the view that the control threshold has not been reached, and therefore remains inactive. In this scenario, private enforcement by the minority shareholders becomes an issue. The German Takeover Act takes a rather complicated approach to this issue. It does not provide the minority shareholders with a direct claim against the controlling shareholder,[48] nor does it provide them with a claim against BaFin to enforce the mandatory bid obligation.[49] Instead, a controlling shareholder who is in breach of the mandatory bid obligation is barred by law from exercising any shareholder rights (voting rights, dividend rights etc.) in the target company.[50] As a consequence, the controlling shareholder is also barred from taking part in any shareholders' meetings and resolutions. If, despite this, a shareholder resolution is adopted with the votes of the controlling shareholder and his/her votes have influenced the outcome of the vote, each minority shareholder is entitled to bring an action to set aside the resolution. Through this indirect route, the minority shareholders are able to put pressure on the controlling shareholder to comply with the mandatory bid obligation.

Not surprisingly, this approach of only indirect private enforcement has been met with substantial criticism. There is much to be said for the view that it would be preferable not only for the minority shareholders, but also (and in particular) for the potential bidder and the company to have the possibility of clarifying the issue of the mandatory bid obligation directly, instead of postponing the decision until an action to set aside a shareholder resolution is brought.[51] Austrian takeover law, for example, offers a special set of proceedings for such cases,[52] which is often cited as a potential model for reform in the German debate. The call for reform, however, has yet remained unheard.

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[47] § 60 para. 1 no. 1 a) Takeover Act. Under § 60 para. 3 Takeover Act (as amended) the maximum fine is now 5 million Euros, but if the wrongdoer's benefit from the breach is higher, the fine may exceed that amount; § 17 para. 3 Act on Regulatory Offences (*Ordnungswidrigkeitengesetz*).

[48] BGH, 11 June 2013, II ZR 80/12, Neue Zeitschrift für Gesellschaftsrecht 2013, 939.

[49] OLG Frankfurt am Main, 5 December 2011, WpÜG 1/11, Neue Zeitschrift für Gesellschaftsrecht 2012, 302.

[50] § 59 Takeover Act. The prevailing view in the legal literature is that this loss of rights only ensues in case of a culpable (i.e. negligent or intentional) breach; see U. NOACK/D. ZETZSCHE, in: Schwark/Zimmer (eds.), Kapitalmarktrechts-Kommentar (4th ed., Munich 2010) § 59 WpÜG para. 6; M. G. KREMER/H. OESTERHAUS, in: Hirte/von Bülow (eds.), Kölner Kommentar zum WpÜG, (2nd ed., Cologne 2013), § 59 paras. 44–45.

[51] For a more detailed discussion, see D. A. VERSE, Rechtsschutz der Zielgesellschaft und ihrer Aktionäre im Übernahmerecht, in: Mülbert/Kiem/Wittig, *supra* note 37, 276, 296–299, with further references.

[52] Cf. § 26b, 33 para. 1 sent. 1 no. 2, para. 2 Austrian Takeover Act *(Übernahmegesetz)*.

III. The Minimum Pricing Rules

1. Identical Pricing Rules for Mandatory Bids and Takeover Bids

A crucial factor for the protection of the minority shareholders is obviously the pricing of the bid. In Germany, unlike for example in the UK,[53] the pricing of mandatory offers and (voluntary) takeover offers is subject to the same rules.[54] The underlying reason is that if control is acquired by way of a takeover bid, the new controller is thereafter exempt by law from the mandatory bid obligation (in order to avoid the burden of having to run two consecutive bids).[55] In other words, the takeover offer replaces the mandatory offer. As a consequence, the German legislator took the view that the takeover offer must also be subject to the same minimum pricing regime.[56]

2. Contents of the Minimum Pricing Rules

As mentioned before, there are two main rules for determining the minimum offer price: the highest price rule and the stock market price rule. Under the former rule, the offer price must be no less than the highest price paid, or agreed to be paid, by the bidder (or a concert party) for shares[57] of the target company in the six months before the publication of the offer document[58]. The purpose of this rule is to ensure the equal treatment of shareholders, particularly the equal distribution of any control premium (*supra* at II. 2). Additionally, under the stock market price rule, the offer price must not fall short of the weighted average stock market price in the three months prior to the bidder's disclosure of his/her intention to launch an offer or (in the case of a mandatory bid) his/her acquisition of control.[59] If, in the case of a mandatory bid, the bidder fails without undue delay to announce the acquisition

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[53] See Rule 9.5 UK Takeover Code (for mandatory bids) as opposed to Rule 6.1 (for voluntary bids); KERSHAW, *supra* note 24, 8.21.

[54] §§ 31, 39 Takeover Act, §§ 3–7 Offer Regulation.

[55] § 35 para. 3 Takeover Act (based on Art. 5 para. 2 TOD).

[56] See the explanatory notes of the German government on the introduction of the Takeover Act, Bundestags-Drucksache (German Parliament document) 14/7034, 60.

[57] Or convertible bonds converted into shares by the bidder; see BGH, 7 November 2017, II ZR 37/16, *McKesson/Celesio,* Neue Zeitschrift für Gesellschaftsrecht 2018, 106; M. BRELLOCHS, Zur Angemessenheit der Gegenleistung im Übernahmerecht – Besprechung von BGH, Urt. v. 7.11.2017, II ZR 37/16 (McKesson/Celesio), Zeitschrift für Unternehmens- und Gesellschaftsrecht 2018, 811; K. D. STEPHAN, Zivilrechtlicher Rechtsschutz im Übernahmerecht nach der ‚McKesson'-Entscheidung, Der Konzern 2018, 45, 50–52.

[58] § 4 Offer Regulation (which implements Art. 5 para. 4 sent. 1 TOD for mandatory bids).

[59] § 5 Offer Regulation. Note that the stock market price rule is not required by the TOD, but it can also be found in several other EU member states; see MARCCUS PARTNERS, *supra* note 6, 157–158.

of control or to launch the bid, the relevant time-periods for the stock market price and the highest price rule will be adjusted accordingly, so that the bidder cannot benefit from any such delay.[60]

These pricing rules need to be strictly complied with; BaFin has no discretion to grant any dispensation or extension. As a matter of principle, both pricing rules need to be complied with cumulatively. If, however, the bidder has neither acquired nor agreed to acquire any shares in the six months before the offer, the highest price rule obviously has no bearing. In this case, the minimum offer price will be determined only on the basis of the stock market price.

In addition to the above rules, the minimum consideration also depends on whether or not the bidder decides to acquire further target shares outside the bid during or shortly after the offer period. If, during the offer period, the bidder acquires shares outside the bid at a higher price than the offer price, the offer price will rise accordingly by operation of law.[61] The same applies, albeit only in the case of off-market transactions, if the bidder acquires further shares in a one-year period after the bid.[62]

In the academic debate, several reform proposals have been raised with regard to the pricing rules. In particular, the stock market price rule is sometimes viewed as too rigid and inflexible, for example in cases of ailing companies. Therefore, some argue that BaFin should be given the power to dispense from this rule in cases where the stock market price evidently does not reflect the fair value of the company.[63] Others even plead for abolishing the stock market price rule altogether, at least for (voluntary) takeover offers.[64] The main concern that has arisen in German takeover practice, however, is a different one. In a number of prominent cases, the bidders have successfully tried to design the takeover in a way that sidesteps the application of the highest price rule and the equal distribution of the control premium. This strategy has become known as "low balling" or "creeping in" and deserves closer attention.

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[60] BGH, 29 July 2014, II ZR 353/12, *Deutsche Bank/Postbank,* Neue Zeitschrift für Gesellschaftsrecht 2014, 985, paras. 34–35; D. A. VERSE, Neues zum Rechtsschutz der Aktionäre im Übernahmerecht, Der Konzern 2015, 1, 5–6.

[61] §§ 31 para. 4, 39 Takeover Act (which implement art. 5 para. 4 sent. 2 TOD for mandatory bids).

[62] §§ 31 para. 5, 39 Takeover Act. This provision is not required by the TOD and rather exceptional among the EU member states; see HOPT, *supra* note 29, 183–184.

[63] C. CASCANTE/J. TYROLT, 10 Jahre WpÜG – Reformbedarf im Übernahmerecht?, Die Aktiengesellschaft 2012, 97, 110.

[64] See, e.g., KRAUSE, in: Assmann/Pötzsch/Schneider, *supra* note 4, § 31 no. 13; VON BÜLOW, 10 Jahre WpÜG – eine kritische Bestandsaufnahme, in: Mülbert/Kiem/Wittig, *supra* note 37, 1, 36–38.

3. *Low Balling/Creeping in*

The issue is best illustrated by an example that, with some simplifications, is based on a real case:[65]

Acquirer A wishes to acquire a 70% stake in listed company T from Seller S at a price of 45 Euros per T-share. In order to avoid the application of the highest price rule, A and S agree as follows: In a first step, A acquires a 29.9% stake of T-shares from S at a price of 45 Euros per share in December 2017. Simultaneously, A enters into a call option agreement with S conferring A the right to acquire another stake of T-shares (40.1%) in 2020 at a price of 45 Euros per share. On 1 July 2018, A announces his intention to launch a takeover offer. On this date, the average stock market price amounts to 25 Euros. What is the minimum consideration to be offered by A: 45 Euros or only 25 Euros per share?

Under the stock market price rule, the answer is simple (25 Euros). But how about the highest price rule? A acquired the shares from S at a price of 45 Euros per share, but that was already in December 2017, more than six months before the offer.[66] It is thus not encompassed by the highest price rule. The same result applies to the call option agreement: It was entered into more than six months before the offer, and when the option becomes exercisable in 2020, this will be more than one year after the expiry of the offer period. This means that the share acquisition upon exercise of the option will also escape the highest price rule for share dealings after the bid.

As a result, therefore, A is entitled to run the takeover bid at a price of 25 Euros per share, not 45 Euros. By structuring the takeover in the described manner, the bidder is thus able to cross the control threshold by launching a takeover bid at a price which does not reflect the control premium. This is clearly against the spirit of the highest price rule, but the Federal Court of Justice held that under the existing provisions in Germany, it could not require a different result to be reached.[67]

Similar "low balling" strategies (with some variations) were used in a number of significant takeovers in Germany. If one accepts the basic assumption

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[65] Cf. BGH (Federal Court of Justice), 29 July 2014, II ZR 353/12, *Deutsche Bank/ Postbank,* Neue Zeitschrift für Gesellschaftsrecht 2014, 985. For a more detailed analysis of this case, see VERSE, *supra* note 60, 1, 4–5.

[66] Note that under German law, A was under no obligation to launch a bid directly after the transaction in December 2017. This transaction did not trigger the mandatory bid obligation, because (i) A only acquired a 29.9% stake, and (ii) under German law the shares covered by the call option agreement are not attributable to him before the exercise of the option; see BGH, 29 July 2014, II ZR 353/12, *Deutsche Bank/Postbank,* Neue Zeitschrift für Gesellschaftsrecht 2014, 985, para. 40, with further references; for a different view, see U. H. SCHNEIDER, in: Assmann/Pötzsch/Schneider, *supra* note 4, § 30 no. 129–136.

[67] BGH, 29 July 2014, II ZR 353/12, *Deutsche Bank/Postbank,* Neue Zeitschrift für Gesellschaftsrecht 2014, 985, paras. 30–32; see also VERSE, *supra* note 65, 4–5. For a different view see, however, U. WACKERBARTH, in: Münchener Kommentar zum Aktiengesetz, vol. 6, (4th ed., Munich 2017) § 31 WpÜG paras. 84a–84b.

that the control premium ought to be distributed equally between all shareholders willing to sell their shares, this state of the law is unsatisfactory. Unsurprisingly, therefore, it has provoked criticism by the European Commission,[68] and it has sparked a debate in Germany if and how such low-ball offers should be prevented in the future. Many other EU member states address the issue by providing for a second mandatory bid threshold; in these jurisdictions, a shareholder holding between 30% and 50% of the voting rights is obligated to launch a mandatory bid as soon as he/she acquires further voting shares.[69] A few years ago, there was a debate whether a similar "creeping in" provision should also be introduced in Germany,[70] but at least currently the German government shows no willingness to adopt this proposal. For the time being, therefore, low-ball offers continue to be a tolerated practice in Germany.

4. *Enforcement*

Last but not least, the enforcement of the pricing rules is an issue which has been dealt with quite extensively in Germany. BaFin reviews the offer document before it is published,[71] and in this context, it also examines whether the offer complies with the pricing rules. In order to ensure a speedy procedure, however, BaFin is entitled to prohibit the bid only if it is incomplete or evidently in breach of the law.[72] Now, let us assume that BaFin (mistakenly) allows the offer to proceed, although the offer price falls short of the required minimum price. Are the shareholders then entitled to bring a claim against BaFin (in order to cause BaFin to stop the bid or to issue an order against the bidder to raise the offer price), or do they have a claim directly against the bidder?

This issue has been the subject of various court decisions over the years. On the one hand, it was decided that the shareholders have no standing to challenge BaFin's decision to allow the bid to proceed and to force BaFin to take actions against the bidder.[73] On the other hand, the Federal Court of Justice held that the shareholders are entitled to bring a claim directly against the bidder for

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[68] European Commission, Report on the application of Directive 2004/25/EC on takeover bids, COM(2012) 347, n. 18, 25.

[69] For a comparative overview, see MARCCUS PARTNERS, *supra* note 6, 130; HOPT, *supra* note 29, 177. A further possibility to address the low balling issue would be to introduce a minimum acceptance quota for the bid as stipulated in Rules 9.3 and 10 of the UK Takeover Code; see EUROPEAN COMMISSION, *supra* note 68, no. 25.

[70] In 2010, two legislative proposals for reform were introduced by the Social Democratic Party and by the Federal State of North Rhine-Westphalia (Bundestags-Drucksache [German Parliament document] 17/3481, Bundesrats-Drucksache [German Federal Council document] 584/2/10), but both failed. For a discussion of the pros and cons, see T. BAUMS, Low Balling, Creeping in und deutsches Übernahmerecht, Zeitschrift für Wirtschaftsrecht 2010, 2374; HOPT, *supra* note 29, 178–179; HABERSACK, *supra* note 28, 37–39.

[71] § 14 Takeover Act.

[72] § 15 para. 1 nos. 1–2 Takeover Act.

payment of the balance between the offer price and the required minimum price.[74] However, this was only decided for shareholders who accepted the offer within the offer period. The court did not cover the question whether and in which circumstances the non-accepting shareholders are also entitled to bring claims against the bidder if, after the end of the offer period, it becomes apparent that the offer price was too low. In the legal literature this is a controversial issue, because the Takeover Act does not contain any guidance on this subject. Some authors argue that the non-accepting shareholders should have a claim against the bidder based on *culpa in contrahendo,* if (i) the bidder acted negligently, and (ii) the shareholder is able to prove that he/she would have accepted the offer had it been made at the correct price.[75] Whether this approach will find the recognition of the courts remains to be seen.[76]

IV. Conclusion

All in all, it appears fair to say that, in general, the German Takeover Act has proved to be a reliable and practicable regulatory framework for the roughly 500 bids conducted under the Act since 2002. The Act, as well as the jurisprudence and the rich academic debate which has developed in relation to it, may serve as a fruitful source of inspiration for lawmakers, academics and practitioners abroad. Still, as we have seen, several shortcomings of the Act have also become apparent over the years, both with respect to the pricing rules (low balling) and the MBR (especially in the field of private enforcement). It is therefore unfortunate that, at least currently, there are no concrete plans for reform on the government's agenda, neither at the national nor at the EU level.

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[73] OLG Frankfurt am Main, 5 December 2011, WpÜG 1/11, Neue Zeitschrift für Gesellschaftsrecht 2012, 302; see also VERSE, *supra* note 51, 277, 278–284, with further references. Note that the Higher Regional Court (OLG) Frankfurt am Main is both first and last instance for challenging BaFin decisions in takeover matters, §§ 48 para. 4, 67 Takeover Act.

[74] BGH, 29 July 2014, II ZR 353/12, *Deutsche Bank/Postbank,* Neue Zeitschrift für Gesellschaftsrecht 2014, 985, paras. 21–27, with case note by VERSE, *supra* note 65, 1–4.

[75] M. AISENBREY, Die Preisfindung im Übernahmerecht (Baden-Baden 2017) 142–150; C. ZSCHOCKE, Zum Schutz des nicht annehmenden Aktionärs nach dem WpÜG, in: Spindler/Wilsing/Butzke (eds.), Festschrift für Reinhard Marsch-Barner (Munich 2018), 607, 618–623. For the contrasting view, see BRELLOCHS, *supra* note 57, 818–819; STEPHAN, *supra* note 57, 50.

[76] In a recent judgment by the OLG Stuttgart, 21 November 2018 (9 U 118/18, as yet unreported), the court left the matter undecided because in the case at hand, the bidder's breach of the pricing rules was, in the opinion of the court, based on an excusable mistake of law and hence not negligent.

Characteristics of the Japanese Tender Offer System and its Rationale

Masakazu Shirai[*]

I. Introduction

In Japan, the term "tender offer" means offering to purchase shares or soliciting offers to sell them from numerous unspecified persons through a public notice, and then effecting their purchase outside of a financial instruments exchange market.[1] Such purchases of shares are carried out primarily with the intent of acquiring or strengthening control over a company. When a tender offer is made, the provisions of the Financial Instruments and Exchange Act (i) ensure that all shareholders are treated equally by giving them the opportunity to sell the shares in their possession on equal terms and (ii) enable shareholders to decide whether or not to sell their shares based on adequate information.

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[1] Art. 27-2 para. 6 of the Financial Instruments and Exchange Act.

Under the Japanese tender offer system, when shares issued by an issuer required to submit an annual report are purchased outside a financial instruments exchange market, by a person other than the issuer, from more than ten persons within a period of sixty-one days, and after that purchase the ownership ratio of shares of the person who effects the purchase will exceed five percent, then the purchase of those shares must be effected by means of a tender offer.[2] Further, even if shares issued by an issuer required to submit an annual report are purchased outside of a financial instruments exchange market by a person other than the issuer from ten or fewer persons within a period of sixty-one days, the purchase of those shares must be effected by means of a tender offer if after that purchase the ownership ratio of shares of the person who effects the purchase will exceed one-third.[3] The former rule governing when implementation of a tender offer is compulsory is generally referred to as the five percent rule; the latter as the one-third rule.

When conducting a tender offer in accordance with the above rules, the tender offeror need purchase only the number of shares requested, with one exception: if the tender offeror's ownership ratio of shares will be two-thirds or more after the purchase, the offeror must purchase all the tendered shares[4] (the buy-all requirement). The Financial Instruments and Exchange Act also designates cases where a solicit-all requirement is imposed on tender offerors on the same principle as the buy-all requirement. If the tender offeror's ownership ratio of shares will be two-thirds or more after the purchase, it must in principle implement a tender offer for all the shares issued by the issuer of the shares in question.[5]

This article will detail the characteristics of the apparently complicated Japanese tender offer system and the rationale behind it. The remainder of this article proceeds as follows. Section II and Section III provide an overview of the Japanese tender offer system. Then, Section IV discusses the characteristics of the tender offer system adopted in Japan as compared to that of other countries. Based on the discussion of Section IV, Section V analyses the rationale behind the tender offer system in Japan.

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[2] Art. 27-2 para. 1 item (i) of the Financial Instruments and Exchange Act; Art. 6-2 para. 3 of the Financial Instruments and Exchange Act Implementing Order.

[3] Art. 27-2 para. 1 item (ii) of the Financial Instruments and Exchange Act; Art. 6-2 para. 3 of the Financial Instruments and Exchange Act Implementing Order.

[4] Art. 27-13 para. 4 of the Financial Instruments and Exchange Act; Art. 14-2-2 of the Financial Instruments and Exchange Act Implementing Order.

[5] Art. 27-2 para. 5 of the Financial Instruments and Exchange Act; Art. 8-5 item (iii) of the Financial Instruments and Exchange Act Implementing Order.

II. Types of Transactions Subject to Tender Offer Regulations in Japan

1. General Observations

Transactions subject to tender offer regulations in Japan can be broadly divided into three types: first, the purchase of shares effected outside of a financial instruments exchange market;[6] second, the purchase of shares effected by combining transactions on and off a financial instruments exchange market over a specified period;[7] and third, the purchase of shares that are already the object of a tender offer, whose purchase is effected by an investor owning more than a specified volume of those shares.[8]

Below we will review the types of transactions subject to tender offer regulations as defined in each item of Art. 27-2 para. 1 of the Financial Instruments and Exchange Act.

2. Purchases Meeting the Five Percent Rule

The first type of transaction subject to tender offer regulations is a transaction meeting the criterion known as the five percent rule. Specifically, when shares issued by an issuer required to submit an annual report are purchased outside of a financial instruments exchange market by a person other than the issuer from more than ten persons within a period of sixty-one days,[9] and after that purchase the ownership ratio of shares of the person who effects the purchase will exceed five percent, then the purchase of those shares must be effected by means of a tender offer.[10]

However, even if a purchase of shares meets the five percent rule, implementing a tender offer is not compulsory in the cases specified by the Cabinet Order as being equivalent to the purchase and sale of securities on a financial instruments exchange market.[11] Specifically, transactions on an over-the-counter securities market[12] and transactions through a proprietary trading

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[6] Art. 27-2 para. 1 items (i)-(iii) of the Financial Instruments and Exchange Act.

[7] Art. 27-2 para. 1 item (iv) of the Financial Instruments and Exchange Act.

[8] Art. 27-2 para. 1 item (v) of the Financial Instruments and Exchange Act.

[9] To be more precise, where the total of the number of persons who are counterparties to the purchase of the shares and the number of counterparties of purchases of shares issued by the issuer of the shares made outside the financial instruments exchange market during the sixty days prior to the day on which that purchase is to be made is more than ten persons.

[10] Art. 27-2 para. 1 item (i) of the Financial Instruments and Exchange Act; Art. 6-2 para. 3 of the Financial Instruments and Exchange Act Implementing Order.

[11] Art. 27-2 para. 1 item (i) of the Financial Instruments and Exchange Act.

[12] However, because the JASDAQ was reorganized as an exchange securities market in December 2004, there are no over-the-counter securities markets as of the writing of this article.

system (PTS) that have been designated by the Commissioner of the Financial Services Agency as fulfilling certain conditions are specified by Cabinet Order as being equivalent to the purchase and sale of securities on a financial instruments exchange market.[13]

The reason for making implementation of a tender offer compulsory under the five percent rule only in cases where shares are purchased from more than ten persons outside a financial instruments exchange market is that if the number of investors (shareholders) receiving purchase offers for shares is small, there is relatively little need to protect investors.[14] The fewer the investors, the more able they are to act in unison. As a result, investors who receive offers can acquire bargaining power equal or almost equal to that of the offeror, and the parties can negotiate on information disclosure demands and purchase price.

3. Purchases Meeting the One-third Rule

Transactions meeting the criterion known as the one-third rule are the next type of transaction subject to tender offer regulations. Specifically, even if shares issued by an issuer required to submit an annual report are purchased outside of a financial instruments exchange market by a person other than the issuer from ten or fewer persons within a period of sixty-one days, the purchase of those shares must be effected by means of a tender offer if, after that purchase, the ownership ratio of shares of the person who effects the purchase will exceed one-third.[15]

Even if a purchase of shares meets the above one-third rule, implementing a tender offer is, as with the five percent rule, not compulsory in the cases specified by the Cabinet Order as being equivalent to the purchase and sale of securities on a financial instruments exchange market.[16] In that case, however, while transactions on an over-the-counter securities market are "equivalent to the purchase and sale of securities on a financial instruments exchange market" as with the five percent rule, transactions over a proprietary trading system (PTS) are not,[17] unlike in the case of the five percent rule. Thus, it must be noted, the one-third rule applies to transactions over a proprietary trading system (PTS).

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[13] Art. 6-2 para. 2 of the Financial Instruments and Exchange Act Implementing Order.

[14] T. Kato, *Kōkai kaitsuke seido* [The tender offer system], in: Yamashita/Kanda (eds.), *Kinyū shōhin torihiki hō gaisetsu* [Overview of the Financial Instruments and Exchange Act] (2nd ed., Tōkyō 2017) 272.

[15] Art. 27-2 para. 1 item (ii) of the Financial Instruments and Exchange Act; Art. 6-2 para. 3 of the Financial Instruments and Exchange Act Implementing Order.

[16] Art. 27-2 para. 1 item (ii) of the Financial Instruments and Exchange Act.

[17] Art. 6-2 para. 4 of the Financial Instruments and Exchange Act Implementing Order.

4. *Purchase by Means of Specified Purchase and Sale*

When shares issued by an issuer required to submit an annual report are purchased by a person other than the issuer by means of "specified purchase and sale," and as a result, the ownership ratio of shares of the person who effects the purchase will, after that purchase, exceed one-third, the purchase of those shares must be effected by means of a tender offer.[18]

"Specified purchase and sale" is defined here as a purchase and sale of securities on a financial instruments exchange market which is specified by the Prime Minister as being a purchase and sale of securities based on a method other than an auction method. Specifically, off-floor transactions conducted on financial instruments exchanges nationwide, such as ToSTNeT transactions on the Tokyo Stock Exchange, are classified as a "specified purchase and sale." These off-floor transactions are, formally speaking, transactions on a financial instruments exchange market, but because neither time priority nor price priority applies, they are considered to be in effect over-the-counter transactions not conducted by auction. Thus, if the ownership ratio of shares will exceed one-third as a result of the specified purchase and sale, implementation of a tender offer is required. To prevent overregulation of off-floor trading, off-floor transactions are not subject to tender offer regulations as long as the ownership ratio of shares after the purchase remains within one-third.

5. *Rapid Purchases Combining On- and Off-market Transactions*

Under the one-third rule, implementation of a tender offer is compulsory if the ownership ratio of shares will exceed one-third as a result of the purchase of shares outside a financial instruments exchange market. It thus used to be easy to circumvent the regulations based on the one-third rule by, for example, purchasing 32 percent of the shares outside of the market and then purchasing two percent on the market or acquiring two percent through a private placement of new shares. Therefore, to prevent such evasive transactions that circumvent the one-third rule, the 2006 revision of the Financial Instruments and Exchange Act introduced a new regulation governing rapid purchases combining on- and off-market transactions.

Specifically, this regulation is as follows. If (a) more than ten percent of the total number of shares issued by the issuer of the shares subject to acquisition are acquired within three months through the purchase of shares or through the "acquisition of a new issue" (meaning the acquisition of shares newly issued by their issuer) and (b) in the transaction in (a), more than five percent of the total number of shares issued by the issuer of the shares subject to acquisition are acquired through a purchase of shares that is effected through a "specified purchase and sale" (i.e. off-floor trading) or that is effected outside a financial

[18] Art. 27-2 para. 1 item (iii) of the Financial Instruments and Exchange Act.

instruments exchange market (excluding purchase effected through a tender offer) and (c) as a result of the transaction in (a), the ownership ratio of shares will exceed one-third, then the purchase of the shares included in the transaction in (a) must be effected by means of a tender offer.[19] Thus, to prevent circumvention of the one-third rule, acquisition of more than ten percent of shares within three months is regarded as a single series of acts, and if all of conditions (a) through (c) are met, implementation of a tender offer is compulsory for the purchase of the shares included in the transaction in (a).

Because the above regulation makes implementation of a tender offer compulsory for the purchase of the shares included in the transaction in (a), the regulation governing rapid purchases combining transactions on and off financial instruments exchange markets serves not only to prevent circumvention of the one-third rule but also to limit the speed of corporate buyouts. For example, if a person already owning 25 percent of the shares purchases a further seven percent off the market, that person cannot acquire new shares in excess of three percent through a private placement until three months have elapsed from that purchase of seven percent off the market.[20] This is because if the person did acquire new shares in excess of three percent through a private placement within three months, the regulation governing rapid purchases combining transactions on and off financial instruments exchange markets would apply, as a result of which the original purchase of seven percent outside the market would have had to be effected by means of a tender offer. For that reason the regulation governing rapid purchases combining transactions on and off financial instruments is sometimes referred to as the "speed regulation."

6. *Competing Purchases during the Tender Offer Period*

In principle, a tender offeror (including a specially related party)[21] must not purchase shares subject to the tender offer by means other than through the

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[19] Art. 27-2 para. 1 item (iv) of the Financial Instruments and Exchange Act; Art. 7 paras. 2–4 of the Financial Instruments and Exchange Act Implementing Order.

[20] Note also that this prohibition on acquisition of more than three percent of the shares within three months applies not only in the case of private placements of new shares as explained in the text; it also applies in the case of acquisition of shares on the market or by tender offer.

[21] "Specially related parties" are defined according to either formal or substantive criteria. A specially related party as defined by formal criteria is any person with whom the offeror has a shareholding relationship, familial relationship or other special relationship specified by Cabinet Order (Art. 27-2 para. 7 item (i) of the Financial Instruments and Exchange Act; Art. 9 of the Financial Instruments and Exchange Act Implementing Order); an example is a stock company in which the offeror owns shares representing at least twenty percent of the voting rights of all shareholders. (Art. 29-4 para. 2 of the Financial Instruments and Exchange Act). A specially related party as defined by substantive criteria is any party with whom the offeror has agreed on so-called joint action. Specifically, (a) a

tender offer during the tender offer period.[22] This is the so-called prohibition of separate purchase. The prohibition of separate purchase was established because the acquisition by a single offeror of the same shares on different terms, whether on or off the market, would result in unfairness to shareholders offering their shares.

On the other hand, until the 2006 revision of the Financial Instruments and Exchange Act, a person other than the tender offeror was able, during the tender offer period, to acquire shares subject to a tender offer by a means other than a tender offer, even if that person was a major shareholder of the company issuing those shares. However, it would seem unfair if, during a struggle for control of a company, the tender offeror was required to acquire shares through a tender offer, yet other major shareholders could freely buy up large numbers of shares from the market without being required to implement a tender offer.[23] Therefore, a regulation governing competing purchases during the tender offer period was adopted in the 2006 revision of the Financial Instruments and Exchange Act with the objectives of ensuring equality between buyers during corporate buyouts and enabling investors (shareholders) to decide, in light of adequate information, which party is better suited to controlling the company.[24]

Specifically, when, during the period of a tender offer by a certain person, a shareholder whose ownership ratio of the shares subject to the tender offer exceeds one-third effects a purchase in excess of five percent of those shares, whether on or off a financial instruments exchange market, that purchase must be effected by means of a tender offer.[25] The reason for restricting the scope of the regulation to large shareholders whose ownership ratio already

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person with whom the offeror has agreed to jointly acquire or transfer the shares, (b) a person with whom the offeror has agreed to jointly exercise voting rights or other rights as shareholders in the issuer of the shares or (c) a person whom the offeror has agreed to transfer the shares to or to acquire the shares from after the purchase of the shares constitutes a specially related party as defined by substantive criteria (Art. 27-2 para. 7 item (ii) of the Financial Instruments and Exchange Act).

[22] Art. 27-5, main clause of the Financial Instruments and Exchange Act.

[23] M. KONDO et al., *Kinyū shōhin torihiki hō nyūmon* [Introduction to the Financial Instruments and Exchange Act] (4th ed., Tōkyō 2015) 373.

[24] However, ensuring provision of adequate information to shareholders must be understood as merely a secondary objective of the regulation governing competing purchases during the tender offer period (see E. KURONUMA, *Kigyō baishū rūru toshite no kōkai kaitsuke kisei* [Tender offer regulations as corporate buyout rules], Jurist 1346 (2007) 28), because if the preceding purchase of shares takes place on a financial instruments exchange market, major shareholders are not required to implement a tender offer. Thus, requiring major shareholders to implement a tender offer through the regulation governing competing purchases during the tender offer period dovetails primarily with the imposition of certain trade restrictions on the tender offeror in a preceding tender offer.

[25] Art. 27-2 para. 1 item (v) of the Financial Instruments and Exchange Act; Art. 7 paras. 5 and 6 of the Financial Instruments and Exchange Act Implementing Order.

exceeds one-third is to avoid overregulation that could adversely affect the secondary market. The applicable tender offer period during which purchase by large shareholders is restricted is understood to be from the first to the last day of the tender offer period specified in the tender offer statement and not to include any extension of that period by the tender offeror.[26]

III. The Buy-all Requirement and the Solicit-all Requirement

In Japan, when effecting a tender offer, a tender offeror can, in principle, purchase only the number of shares requested. Thus, so-called partial tender offers are permitted in Japan. Specifically, a tender offeror is able to acquire only the number of shares sought, without having to acquire them all, as long as it has included in the public notice of the commencement of the tender offer[27] and the tender offer statement[28] the condition that if the total number of tendered shares exceeds the number of shares sought for purchase, it will not purchase all (or any, as the case may be) of the shares tendered in excess of the number of shares sought for purchase.[29] Further, if a partial tender offer is effected and the total number of tendered shares exceeds the number of shares sought for purchase, the Financial Instruments and Exchange Act requires that the tendered shares be acquired using a pro rata method[30] in order to ensure that tendering shareholders are treated equally regardless of when they accept the offer.[31]

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[26] N. MATSUO, *Kinyū shōhin torihiki hō* [The Financial Instruments and Exchange Act] (5th ed., Tōkyō 2018) 252.

[27] In Japan, tender offer procedures begin with the issuance of a public notice of the commencement of a tender offer by the tender offeror (Art. 27-3 para. 1 of the Financial Instruments and Exchange Act). The public notice of the commencement of a tender offer is an important means of notifying investors (shareholders) of the implementation of a tender offer and its specifics.

[28] The tender offer statement consists of a document stating the particulars prescribed in Art. 27-3 para. 2 of the Financial Instruments and Exchange Act, along with the accompanying documents. The tender offeror must submit the tender offer statement on the day on which it issues the public notice of the commencement of the tender offer. The submitted tender offer statement is kept available for public inspection for five years from the close of the tender offer (Art. 27-14 para. 1 of the Financial Instruments and Exchange Act).

[29] Art. 27-13 para. 4 item (ii) of the Financial Instruments and Exchange Act.

[30] The pro rata method entails multiplying the number of shares that the tendering shareholder actually tenders by the ratio of the shares for which purchase is to be made in relation to the total number of voting rights pertaining to all the shares tendered (Art. 32 para. 1 Cabinet Office Ordinance on Disclosure Required for Tender Offer for Shares, etc. by Person Other than Issuer). If the number obtained by this calculation includes a fraction of less than one share, it is rounded off to a whole number.

There is, however, an important exception to the above principle: if the tender offeror's ownership ratio of shares will be two-thirds or more after the purchase, a requirement to purchase all the tendered shares (the buy-all requirement) is imposed on it.[32] The rationale for restricting the implementation of partial tender offers and imposing a buy-all requirement on the tender offeror is to protect the interests of investors (shareholders) who, after the close of the tender offer, are forced to hold on to shares that were not subject to purchase. If the tender offeror's ownership ratio of shares is two-thirds or more after the purchase, the target company's shares may be difficult to dispose of because, for example, they have been delisted, and under the Japanese Companies Act shareholders other than the tender offeror will basically lose their veto over extraordinary resolutions in shareholders meetings. Consequently, in this case alone, it was thought appropriate to impose a buy-all requirement on tender offerors in addition to restricting partial tender offers.[33]

The Financial Instruments and Exchange Act also defines cases where a solicit-all requirement is imposed on tender offerors on the same principle as the buy-all requirement. Specifically, if the tender offeror's ownership ratio of shares will be two-thirds or more after the purchase, it must, in principle, offer to purchase, or solicit offers to sell, all the shares issued by the issuer of the shares in question.[34]

IV. Evolution and Characteristics of the Japanese Tender Offer System

1. Evolution of the Tender Offer System in Japan

The Japanese tender offer system was introduced in 1971 by a revision to the Securities and Exchange Act, taking as its model the Williams Act enacted by the United States in 1968. In the United States, before the Williams Act was enacted, it often happened that, in a takeover strategy termed the "Saturday night special," a short tender deadline was set over the weekend and shares were bought up on a first come, first served basis. This caused fears that shareholders could be induced to sell without being able to reach a considered decision on the reasonableness of the purchase terms. Meanwhile, at roughly

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[31] Art. 27-13 para. 5 of the Financial Instruments and Exchange Act; Art. 32 Cabinet Office Ordinance on Disclosure Required for Tender Offer for Shares, etc. by Person Other than Issuer.

[32] Art. 27-13 para. 4 of the Financial Instruments and Exchange Act; Art. 14-2-2 of the Financial Instruments and Exchange Act Implementing Order.

[33] KONDO et al., *supra* note 23, 379.

[34] Art. 27-2 para. 5 of the Financial Instruments and Exchange Act; Art. 8 para. 5 item (iii) of the Financial Instruments and Exchange Act Implementing Order.

the same time in Japan, overseas investors were expected to start buying up listed companies as the liberalization of capital progressed, and it was considered necessary to establish corresponding regulations; hence the adoption of the tender offer system pursuant to the above revision of the law.

However, for some time after the tender offer system was brought in through the 1971 amendment to the Securities and Exchange Act, there were only a handful of cases of tender offers actually being made in Japan.[35] The Japanese tender offer system was cumbersome at the time, and it was criticized in particular by foreign companies as actually making corporate acquisitions more difficult.[36] Given these circumstances, the tender offer system was completely overhauled by the 1990 revision to the Securities and Exchange Act with a view to bringing it into line with the tender offer systems of other countries, and the one-third rule on compulsory implementation of tender offers was introduced mainly on the model of the European tender offer system.

Following the 1990 revision of the Securities and Exchange Act, the tender offer system came into wide use in Japan as well. But as use of the system spread, problems gradually arose that exposed its defects; to remedy those problems, an attempt was made to improve the system under the 2006 revision of the Financial Instruments and Exchange Act, chiefly with the goals of ensuring fair competition for company control and enhancing provision of information to shareholders. For example, the 2006 revision of the Financial Instruments and Exchange Act mandated tender offers in cases of transactions combining on- and off-market transactions and in cases of competition between different offerors, and it brought in the buy-all requirement. The 2006 revision of the Financial Instruments and Exchange Act was implemented with the goal of remedying problems that had actually occurred in cases of acquisitions in Japan, and the improvements made by it in the tender offer system make a certain amount of sense. On the other hand, it is also a fact that the 2006 revision of the Financial Instruments and Exchange Act has considerably complicated the Japanese tender offer system.

2. Characteristics of the Japanese Tender Offer System

As we can see in Section II and Section III of this article, it is true that the Japanese tender offer system is very complicated. In order to understand the Japanese tender offer system well, a good approach is to capture its characteristics. The following three general observations may be made on the characteristics of the tender offer system adopted in Japan, as compared to that of other countries.

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35 I. KAWAMOTO et al., *Shin Kinyū shōhin torihiki hō tokuhon* [New readings in the Financial Instruments and Exchange Act] (Tōkyō 2014) 109.

36 M. KONDO, *Kōkai kaitsuke seido* [The tender offer system], in: Kawamoto/Tatsuta (eds.), *Kinyū shōhin torihiki hō no ronri to jitsumu* [Theory and practice of the Financial Instruments and Exchange Act] (Tōkyō 2007) 40.

First, the Japanese tender offer system regulates the purchase of shares outside a financial instruments exchange market; implementation of a tender offer is not in principle compulsory if the purchase of shares is effected by means such as a transaction on a financial instruments exchange market or issuing shares for subscription. Thus, in determining when it is compulsory to implement a tender offer, a distinction is made based on whether or not the transaction occurs outside a financial instruments exchange market: only certain purchases of shares effected outside a financial instruments exchange market are subject to regulation, whereas transactions effected on financial instruments exchange markets are not.

Second, in Japan, the conditions under which a tender offer is compulsory and the conditions for imposing the buy-all or the solicit-all requirement vary. The latter may be characterized as stricter than the former. Specifically, under the one-third rule, implementation of a tender offer is compulsory if the ownership ratio of the person purchasing the shares will be one-third or more after the purchase. But even in that case, unless the tender offeror's ownership ratio will be two-thirds or more after the purchase, the solicit-all and the buy-all requirements do not apply, and the tender offeror need purchase only the number of shares requested.

Third, under the tender offer system adopted in Japan, when implementation of a tender offer is compulsory under the five percent rule or the one-third rule, the purchase whereby the ownership ratio of the person conducting it will increase to more than five percent or one-third must itself be effected by means of a tender offer. Thus, in Japan the requirement is not that, upon achieving an ownership ratio of more than five percent or one-third, one must then implement a tender offer for all the remaining shares; rather, a purchase of shares which yields this ownership ratio must itself be done by tender offer. This regulatory approach may be characterized as *ex-ante* regulation in that it requires that the purchase of shares be effected by means of a tender offer at the stage before the ownership ratio of the person conducting the purchase increases to more than five percent or one-third, unlike a regulatory approach requiring that a tender offer be made after the ownership ratio increases to that level.

V. Rationale behind the Tender Offer System in Japan

These, then, are the characteristics of the Japanese tender offer system. What may be considered the rationale behind it? Concisely explaining the rationale behind the Japanese tender offer system is no simple task, for it involves a complex welter of regulations, and the regulatory goals of each cannot always be understood in a way that is consistent with the rest. Nonetheless, its rationale can generally be summarized as follows.

1. The Need to Treat Shareholders Equally and to Provide Adequate Information to Them

The first point that may be cited as part of the rationale behind the Japanese tender offer system is the need to treat shareholders equally and the need to provide adequate information to them (primarily in order to protect shareholders who have received a purchase offer). Where equal negotiations cannot be expected due to disparities in information between the parties, shareholders may feel pressured to sell the shares in their possession, resulting in unfairness. Consequently, in such situations the need arises to protect shareholders by compelling the party that has the information advantage to release the information and give all shareholders an equal opportunity to sell.[37] Thus, in such situations it is necessary to ensure, by making a tender offer compulsory based on the provisions of the Financial Instruments and Exchange Act, that all shareholders are treated equally through the provision of opportunities to sell their shares on equal terms[38] and that they are provided with enough information to decide whether or not to sell their shares. These needs can be adduced as grounds justifying compulsory implementation of a tender offer primarily under the five percent rule.

The need to treat shareholders equally and the need to provide adequate information to them can thus be cited as part of the rationale behind the Japanese tender offer system. How is that to be reconciled with the fact that, under the Japanese tender offer system, only certain purchases of shares effected outside a financial instruments exchange market are subject to regulation, while transactions effected on a financial instruments exchange market are not? In this regard it may be argued that shareholders (investors) are in general treated fairly and equally in financial instruments exchange markets since transactions on them are (a) public in that anyone may participate in them, (b) transparent in that volumes and prices are publicly disclosed and (c) fair in that they are by auction.[39] Thus, in the case of transactions effected on a financial instruments exchange market, it can be reasonable to think that shareholders (investors) will be treated fairly and equally by the market even if imple-

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[37] M. NODA, *Dai 27 jou no 2* [Commentary on Art. 27-2 of the Financial Instruments and Exchange Act], in: Kuronuma/Ota (eds.), *Ronten taikei: Kinyū shōhin torihiki hō 1* [Point by point: The Financial Instruments and Exchange Act 1] (Tōkyō 2014) 286–287.

[38] Nonetheless, in Japan, where, as briefly described in Section III of this article, the buy-all requirement and solicit-all requirement are imposed in only limited situations, the tender offer system cannot be said to guarantee shareholders an opportunity to sell all the shares in their possession. Even in cases where implementing a tender offer is compulsory, unless the buy-all requirement or solicit-all requirement applies, shareholders are given only the opportunity to sell their shares on equal terms; it cannot be argued that they are actually guaranteed the opportunity to sell them all.

[39] KATO, *supra* note 14, 261; KONDO et al., *supra* note 23, 368.

menting a tender offer is not compulsory when purchasing shares.[40] The Financial Instruments and Exchange Act therefore exempts transactions effected on a financial instruments exchange market from the requirement to implement a tender offer. By contrast, transactions effected outside a financial instruments exchange market (typically over-the-counter transactions) are not always highly public, transparent and fair, and it cannot really be claimed that shareholders (investors) are treated fairly and equally with regard to them; hence the need to make implementation of a tender offer compulsory in certain cases.

2. The Need for Equal Distribution of Control Premiums

Second, besides the need to treat shareholders equally and the need to provide adequate information to them, another point that may be cited as part of the rationale behind the Japanese tender offer system is the need for equal distribution of control premiums (in order to protect not those shareholders who have received a purchase offer, but rather those who have not). This need for equal distribution of control premiums can be adduced as grounds justifying compulsory implementation of a tender offer particularly under the one-third rule.

A control premium is the difference between the price (per share) of control stock and its market price. A block of shares large enough to enable one to acquire control of a company is generally referred to as "control stock." When ownership of control stock is transferred, the transfer price is often set higher than the market price of the shares in question (hence the control premium is usually a positive value). If transfer of ownership of the control stock is effected by means of an over-the-counter transaction outside a financial instruments exchange market, the control premium is enjoyed solely by the transferor of the control stock (the controlling shareholder), but if implementing a tender offer is compulsory when transferring ownership of control stock, all shareholders can enjoy a share of the control premium.

By adopting the one-third rule as one condition under which implementation of a tender offer is compulsory, the Japanese tender offer system requires that the control premium be equally distributed among all shareholders instead of letting the transferor of the control stock (the controlling shareholder) monopolize it. As for situations in which the one-third rule applies, only certain purchases of shares effected outside a financial instruments exchange market

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[40] Likewise, with regard to provision of information to shareholders, if a large volume of shares is acquired through a transaction conducted on a financial instruments exchange market, information on that large share acquisition will be reflected in the share price of the target company; thus, shareholders (investors) can trade on the assumption that the share price reflects information on large share acquisitions. Therefore, in the case of transactions effected on a financial instruments exchange market, it can be reasonable to think that less need exists to provide information to shareholders than in the case of transactions effected outside of a financial instruments exchange market.

are subject to regulation under it; in principle, transactions effected on a financial instruments exchange market are not. This is presumably on the grounds that if enough shares are bought up through transactions effected on a financial instruments exchange market to constitute control stock, that can be expected to drive up the target company's share price by being reflected in it, allowing shareholders to enjoy a share (albeit imperfect) of the control premium through the rise in share price. Of course, distribution of the control premium through a rise in share price certainly does not guarantee perfectly equal distribution to shareholders to the same extent as distribution through compulsory implementation of a tender offer does. However, given that implementation of a tender offer entails various costs, making it compulsory in a broad range of cases could in certain regards hinder transactions in control stock per se;[41] thus, the adoption of the above approach by the Japanese tender offer system is, though there is room for dissent, an understandable policy decision.

[41] See KATO, *supra* note 14, 267.

Korean Takeover Laws

Focusing on the Control Premium

Yon Mi Kim

I. Introduction

There are three ways to acquire control in a public company: (i) by purchasing a large enough number of shares on the stock exchange, (ii) by purchasing a block of shares directly from the controlling shareholder(s), or (iii) by making a tender offer bid to public shareholders. The first of these methods is subject to the exchange's trading rules on order matching, price and settlement, while the latter two are not subject to the exchange rules as the transactions are arranged outside the stock exchange. Although all three methods are theoretically possible, this chapter will focus on the latter two methods, as the first one is an unrealistic way to ensure acquisition of a desired block of target shares within a short period of time.

A tender offer according to method (iii) may be used in both hostile and friendly takeover situations, especially when the acquirer wishes to get more control than what controlling shareholders can sell. The Korean Capital Market Law (hereinafter: CMA)[1] has established a tender offer system with detailed procedures and conditions, settlement, a disclosure requirement, and penalties for violations. Transactions under method (ii) are privately negotiated and settled as agreed upon by the relevant parties. As one exception, in certain circumstances, transactions under method (ii) may trigger a tender offer requirement and be subject to the same tender offer regulations as under the method (iii). Other than that, method (ii) is not specifically regulated by CMA. In addition, both methods (ii) and (iii) are subject to disclosure rules and insider trading regulations under CMA.

As such, the tender offer regulations for both hostile and friendly takeovers play an important role in the Korean market for corporate control. The tender offer system was initially introduced to Korea in 1976, but no tender offer was ever made until 1994, when the first tender offer for a Korean listed company was made by a US firm. As the ceiling on ownership of listed shares was abolished in 1994 and Korean capital market gradually became open to foreign investors, Korean and foreign bidders made more tender offer bids, arousing both welcoming attention and concerns. The main fear in business circles was of foreign corporate raiders attempting hostile takeovers.[2] Since 1997, the tender offer system has gone through several amendments, reflecting various voices around the Korean capital market.

The merits of tender offers in the takeover market may include transparency of control transactions, disclosure of information on control transactions to prevent insider trading or market fraud, and protection of minority shareholders in change-of-control events. Another significant role of tender offers is to give all shareholders the opportunity to participate in the deal: to share the control premium.

The existence of a 'competitive market for corporate control' is expected to prevent agency cost by corporate management or controlling shareholders and ultimately enhance corporate governance.[3] The Korean regulatory scheme for takeovers does not aim for a *laissez-faire* market; a certain degree of regulation may bring about a more efficient market while taking care of the interests of various constituents who will be affected by the takeover. For example, the tender offer procedure is designed to ensure equal treatment among shareholders and eliminate undue pressure on minority shareholders to tender their shares, even if it may increase the burden of the bidder. It is not

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[1] Financial Investment Services and Capital Markets Act 2007, Law No. 8635/2007, as amended by Law No. 14817/2017.

[2] H.-J. KIM, The Case for Market and Corporate Control in Korea, Journal of Korean Law 8 (2009) 233.

[3] H. G. MANNE, Mergers and the Market for Corporate Control, Journal of Political Economy 73 (1965) 114.

an easy task to balance the conflicting interests of various stakeholders; Korean takeover laws have been criticized for favoring certain stakeholders over others, directly and indirectly.

There might be more than one way to evaluate the Korean takeover system, but this chapter focuses on the sharing of the control premium. When an acquirer is willing to pay a control premium on the block of shares well in excess of a simple aggregation of the market price, they might be expecting some room to extract such an excess payment from minority shareholders' wealth. If the tender offer system were designed to ensure the sharing of the control premium among all shareholders, the part of the control premium representing such abuse of control would be eliminated. As a result, the corporate governance of Korean corporations would be enhanced through the well-designed tender offer system.

This chapter starts with empirical data on Korean tender offers (II.), then addresses the issues of whether the current tender offer system adequately requires tender offers to be made when necessary (III.), whether tender offer procedures are designed to ensure sharing of the control premium with minority shareholders (IV.), and whether the current tender offer regulations provide for relevant means to prevent misappropriation of the control premium (V.).

II. Overview of Korean Tender Offers: Data

1. Tender Offers in Korea: What Is happening

The Korean tender offer system applies to tender offers of voting shares listed on the Korean stock exchange and securities which may be converted into voting shares, including convertible bonds, exchangeable bonds, and bonds with warrants. The actual number of tender offer bids made for Korean listed companies for recent years is shown in *Table 1.*

Table 1: All Tender Offers (2010–June 2018)

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018 (January–June)	Total
Tender Offers	10	2	15	7	14	17	11	22	9	107

Source: <http://dart.fss.or.kr>

Given that more than 2,000 companies are listed on the Korean stock exchange, it is indisputable that tender offers are not a commonly used takeover scheme in Korea. *Table 2* shows the total size of Korean mergers and acquisitions to mark the current status of tender offers in the corporate control market. The “share transfer transactions” column in *Table 2* covers both private share purchase deals and public transactions such as tender offers.

Table 2: Mergers and Acquisitions in Korea (2016–2017)

Number of Cases	Total[4]	For Listed Companies	Share Transfer (Listed Companies)	Merger (Listed Companies)	Others (Listed Companies)
2016	450	294	82	115	97
2017	638	300	89	125	86

Source: Korea M&A Exchange

Comparing *Table 1* and *Table 2,* one might expect that almost 20% of share transfer transactions in 2017 were conducted through tender offers (22 tender offers among 89 share transfer transactions). This is misleading, as the number of tender offers in *Table 1* covers many offers made for purposes other than takeovers. Korea has only one tender offer system, which is applicable to all tender offers with different aims. *Table 3* shows detailed information on tender offer bids per year.

Table 3: All Tender Offers per Purposes (2010–June 2018)

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018 (January – June)	Total
All Tender Offers	10	2	15	7	14	17	11	22	9	107
Delisting	2	1	7	3	6	5	3	4	–	31
Holding Company Requirement	6	1	6	2	6	9	7	12	7	55
Hostile Takeover	1	–	–	1	–	–	–	–	–	2
Others[5]	1	-	2	1	2	3	1	6	2	19

Source: <http://dart.fss.or.kr>

Tender offers launched in relation to private share purchase transactions are included in the “Others” column in *Table 3.* From this we can see only two cases of tender offers for hostile takeovers, and less than a dozen cases of tender

[4] Mergers and acquisitions by listed companies and other companies with public reporting obligations.

[5] Including acquisition of treasury stock, securing management’s position, securing the controlling shareholder’s position, etc.

offers in relation to friendly takeovers during the period of 2010–2018. In conclusion, tender offers are rarely resorted to in Korean takeover situations.

2. *Few Tender Offers in Korea: The Implication*

Why are there few hostile takeover attempts in Korea? One may give several answers: Korean corporations are not attractive enough or they are armed with effective defensive tactics; controlling shareholders hold significant blocks in most Korean listed companies; the Korean market atmosphere makes it hard to ignore public opinion that is strongly against hostile takeovers; or the tender offer system has inexplicit hurdles to hostile tender offers.

Why are there few tender offers in relation to friendly takeovers in Korea? One might suspect that, unlike in hostile takeover attempts, there are ways other than tender offers to secure a large enough block of shares to guarantee control of the target company. If the acquirer can achieve their goal by paying a control premium exclusively to controlling shareholders, while at the same time paying nothing or much less to minority shareholders, then the acquirer and the controlling shareholders would choose that way over a tender offer. In other words, the current tender offer system in Korea fails to ensure sharing of the control premium by minority shareholders in a takeover situation.

III. Triggering a Tender Offer

A well-designed tender offer system would make sure that it covers all solicitation or public offers to purchase certain securities where disclosure of relevant information and prevention of pressure to tender is required for the protection of shareholders.[6] This subchapter will draw attention to whether Korean law requires a tender offer to be made in all relevant situations.

1. *Overview of the Korean Tender Offer System*

The tender offer system is set forth in Section 1 of Part III, Chapter II of CMA (Arts. 133–146) and relevant regulations promulgated by the Financial Services Commission (FSC).

A tender offer is defined as "to make an offer to unspecified people to purchase […] voting stock or any other securities specified by Presidential Decree or to invite them to sell […] such stocks, etc. and purchase them outside the securities […]."[7] Anyone who intends to make a tender offer shall make a public

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[6] The reasons why we need to take care of the pressure to tender are presented and analyzed in L. A. BEBCHUK, The Pressure to Tender: An Analysis and A Proposed Remedy, Delaware Journal of Corporate Law 12 (1987) 911.

[7] Art. 133 para. 1 CMA.

notice setting forth relevant information required by law and regulations,[8] file the tender offer statement with the FSC,[9] and follow the tender offer procedures stated in CMA. Certain transactions, including acquisition of shares upon exercise of dissenting shareholders' appraisal right and acquisition of shares from "specially related persons," are exempt from the tender offer requirement.[10]

A tender offer is defined as a solicitation to "unspecified people", which is interpreted as a solicitation towards at least a considerable number of shareholders. It is not clear how many shareholders would be counted as a considerable number of targets for a tender offer. It is also not clear whether the number of shares held by targeted persons would count: compare a solicitation towards a hundred of shareholders holding only one share each and an offer to five shareholders holding more than thousands of shares. In order to prevent circumvention of the tender offer definition by narrowing the solicitation to a certain "numerous but specified set of shareholders," CMA provides the conditions of solicitation which will trigger the tender offer requirement. If these conditions are met, the solicitation would be deemed a "tender offer," and the offeror should file a tender offer statement with FSC and follow the tender offer procedures. The triggering conditions are (i) purchase of voting shares outside of the securities market, (ii) from at least 10 persons, (iii) within a period of six months, and (iv) as a result of which, the offeror would hold 5% or more of the voting shares of the target company.[11] In addition, for this purpose, (v) the purchases and holdings of the offeror's "specially related persons" would be aggregated.[12]

When the tender offer requirement is triggered, the offeror should follow the tender offer procedures the same way as someone who intends to launch a tender offer from the start. The same level of disclosure would apply; the offer should be open to all shareholders at the same price and conditions; the offer should last at least 20 days, and during that period the shareholders may cancel their tender without penalty.[13] Korean tender offer regulations do not provide for a minimum amount of control to be acquired through a tender offer; the offeror is permitted to purchase only up to the level of shareholding she desires to obtain.

2. *LG Card Co. Case*

Most of the tender offers were designed as solicitation to unspecified shareholders from the start. The notable case of triggering the tender offer re-

[8] Art. 134 para. 1 CMA.
[9] Art. 134 para. 2 CMA.
[10] Provision to Art. 133 para. 3 CMA.
[11] Art. 133 para. 3 CMA.
[12] Art. 133 para. 3 CMA.
[13] Arts. 134, 139, 141 CMA.

quirement is the acquisition of the shares of LG Card Co. Ltd., a credit card company, which took place in 2007.

a) Background

LG Card suffered financial distress in 2004 and went into an out-of-court restructuring arrangement with its major creditors. By that arrangement, 14 major creditors (all of whom were Korean commercial banks and financial institutions) came to possess a large block of shares in LG Card through a debt-to-equity swap. As the business of LG Card recovered, in 2006, the creditors of LG Card (now controlling shareholders) decided to sell the controlling block to cover the debt.

Through an auction, Shinhan Financial Group was chosen as the buyer to purchase 85% of the outstanding shares of LG Card Co. (which represented all the shares held by the 14 creditor-shareholders) at 68,000 Won per share, while the market price for the target share was less than 60,000 Won.

b) Tender Offer Triggered

According to the plan, (i) the transaction would be conducted outside of the stock exchange where the target shares were listed, (ii) the sellers were 14 persons, (iii) the whole transaction would close within a six-month period, and (iv) as a result, the acquirer would hold 85% of the target's voting shares. The intended transaction triggered the tender offer requirement. In other words, although Shinhan Finance (the buyer) and the 14 creditors (the sellers) agreed to buy and sell 85% of outstanding shares of LG Card outside the exchange, they were forced to go through the tender offer procedures and provide an offer to the remaining minority shareholders.

c) Result of Tender Offer

In March 2007, Shinhan Financial Group filed a tender offer statement and made a tender offer bid open to all shareholders of LG Card, stating that it would purchase up to 85% of shares at 67,770 Won per share (reflecting almost the same amount of control premium). The 14 creditors of LG Card had to tender their shares at the same conditions as the other minority shareholders. Due to the *pro rata* rule, the 14 creditors failed to dispose of all of their shareholdings as other shareholders tendered their shares, while the acquirer would purchase only up to 85%. As the Korean tender offer regulations do not provide for a certain percentage to be acquired by a tender offer, Shinhan Financial Group intended to purchase the same number of shares as it originally agreed with the 14 sellers and not more; with the *pro rata* rule, the 14 creditors would be able to sell at least 85% of their holdings, while all the remaining shareholders would be able to sell 15% of their holdings at best.

In the end, Shinhan Financial Group purchased 85% of the target shares from more than 1,000 persons. From the minority shareholders' view, more than 1,000 shareholders somehow participated in the takeover transaction and received part of the control premium. By the end of 2009, LG Card changed its name to Shinhan Card and became a 100% subsidiary of Shinhan Financial Holding Company.[14]

3. Implications of LG Card Case

After the LG Card case, however, there was not a case where a privately negotiated acquisition triggered the tender offer requirement. The triggering conditions are distinctly stated such that there is little ambiguity; on the other hand, it may be lawfully avoided by designing the transaction carefully. Stretching the deal over six months is one possible option; reducing the number of sellers below ten by transferring the shares among the sellers or using a special purpose vehicle before the closing is another one.

When a circumvention of a certain requirement happens, the regulators are expected to prevent it either through a change of rules or by re-characterizing the situation according to the purpose of the regulations. Until now, the Korean regulators have not shown much eagerness in enforcing the tender offer requirement. In 2009, facing a similar situation for sale of Daewoo Construction shares, instead of having a tender offer, FSC amended the regulations to allow exemptions to the tender offer in the case of restructuring.[15]

Trigger of the tender offer requirement was originally designed to supplement the obscure definition of the tender offer and guarantee all relevant solicitations to be covered by the tender offer system. The Korean regulators' failure to see the importance of sharing the control premium with minority shareholders inevitably leads to negligence in enforcing such a requirement.

IV. Equal Treatment in Tender Offers

Even when the acquirer launches a tender offer to shareholders from the general public in accordance with the tender offer regulations, it does not follow that the minority shareholders have the same opportunity as the controlling shareholders to receive a control premium. This subchapter will draw attention to whether the Korean tender offer system helps minority shareholders to share the control premium.

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[14] Information available at <http://dart.fss.or.kr>.

[15] KOREA SECURITIES LAW ASSOCIATION, *Chusok Jabonsijangbop* [Commentary to Capital Market Act], Vol. I (2nd ed., Seoul 2015) 695.

1. Equal Treatment under Korean Tender Offer System

Equal treatment of shareholders in takeover situations is not only a practical instrument to secure undistorted choice by shareholders, but is in itself a goal to be pursued.[16] The Korean tender offer system also aims to ensure fairness among shareholders.[17] Below are some of the mechanisms in the Korean tender offer regulations to ensure fair and equal treatment among shareholders.

a) Uniform Price

CMA explicitly requires a uniform tender offer price.[18] As such, it is forbidden to structure a two-tier bid where the acquirer announces that they will pay more for the shares tendered within the first tier than for the shares to be tendered in the second tier, which is likely to exert pressure on the shareholders to tender their shares.[19] Should the offeror increase the price during the tender offer period, the increased price applies to all shares tendered during the tender offer period, whether tendered before or after the price increase (best price rule). Furthermore, decreasing the tender offer price or withdrawing/cancelling the tender offer is strictly restricted.

b) Uniform Conditions

Although there is no explicit regulation, it is clear that conditions other than price should be uniformly applied to all shareholders. Consideration should be paid to holders of the tendered shares at the same time under the same conditions. To ensure immediate consideration, Korean tender offer regulations require the bidder to disclose the funding arrangement and submit documents evidencing the existence of the required funds.[20]

c) Pro Rata Rule

The offeror should not favor certain shareholders over others or discriminate against shareholders during the tender offer, which may exert pressure to tender on shareholders. For instance, the offer should be open to all shareholders during the tender offer period. If the number of shares tendered exceeds the target percentage, the offeror should purchase shares in proportion to the number of shares tendered by each shareholder (*pro rata* basis), unless she buys them all. The offeror cannot purchase shares on a first-come, first-served basis.

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[16] L. A. BEBCHUK, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, Harvard Law Review 98 (1985) 1707.

[17] K. KIM, The Tender Offer in Korea: An Analytic Comparison between Korea and the United States, Pacific Rim Law and Policy Journal 10 (2001) 540.

[18] Art. 141 para. 2 CMA.

[19] BEBCHUK, *supra* note 6, 925.

[20] Art. 146 para. 4, items 4 and 5 Enforcement Decree to CMA.

It is not clear, however, whether the offeror may classify shareholders for tender offer purposes. For comparison, in proxy solicitation, it is not uncommon in Korea that the proxy solicitors narrow solicitation to certain types of shareholders (e.g., to shareholders holding 100 shares or more; to individual shareholders only, excluding institutional shareholders; to domestic shareholders only). As a tender offer is inherently open to all shareholders, classification of shareholders and differential treatment thereof in the tender offer bids is likely to invite the regulator's attention and corrective order.

d) Exclusiveness

Once a tender offer bid is made, all acquisition attempts must be conducted through tender offer at the same price and conditions. As such, during the tender period, acquisition of target shares on the exchange or through privately negotiated purchases is not allowed, which may serve as a circumvention of the equal treatment rule.

Article 140 of CMA plainly provides that "no tender offeror […] shall purchase the relevant stocks […] other than through the tender offer from the public notice date of the tender offer until the end of the tender offer period". The proviso to Article 140 of CMA, however, delegates to the Enforcement Decree the allowance of the acquisition of target shares not through a tender offer in situations in which shareholders' interests are not undermined. Under the Enforcement Decree to CMA, acquisition of target shares outside a tender offer is possible if the relevant purchase agreement has been executed before the tender offer and such information is disclosed in the tender offer notice and the tender offer statement.[21] Other than disclosure, there is no restriction on the toehold acquisition so long as the purchase agreement is signed before the launch of the tender offer.

2. Model Case for Control Premium Sharing by Tender Offer

The Korean tender offer system does not regulate tender offer prices other than requiring a uniform price for each tender offer, which is not sufficient to guarantee fair payment of the control premium to minority shareholders. A tender offer case from 2009 shows that an equal share of the control premium may be achieved without detailed restrictions.

a) Phase I: Hostile Takeover Attempted

SD Inc. was a Korean corporation producing medical products, and was listed on the KOSDAQ market. In August 2009, Inverness Medical Innovations, Inc., a global manufacturer of pharmaceutical products, made a tender offer

[21] Art. 151 Enforcement Decree to CMA.

bid to acquire SD. SD responded to resist the hostile attempt. The tender offer was made at 30,000 Won when the market price of target shares was slightly below such a price. After the announcement, the market price kept rising and went far above 30,000 Won during the tender offer period. In the end, not a single share was tendered.

b) *Phase II: Tender Offer Agreed with Management/Controlling Shareholder*

After the failure of the phase I tender offer, the boards of SD and Inverness entered into negotiations and reached an agreement to sell control of the company. In January 2010, Inverness launched a second tender offer with price of 40,000 Won. The board and controlling shareholders of SD gave their consent to the tender offer and made a recommendation to shareholders to tender their shares. The controlling shareholder agreed to tender his shares during the tender offer at the same price and conditions.

Through the second-phase tender offer, Inverness came to possess 59.59% of SD, with the controlling shareholder still holding 20%. The control premium was paid equally to all shareholders.

c) *Phase III: Tender Offer for Delisting*

In February 2010, Inverness made a final tender offer to acquire all remaining shares of SD and delist the company from the KOSDAQ market. The delisting plan was already disclosed in the second tender offer statement. The tender offer price was set at 40,000 Won, the same amount as the second tender offer. After the third tender offer, Inverness came to possess 92.9% of the company. In June 2010, shares of SD was delisted from the KOSDAQ market.

While the company went private, most of the minority shareholders sold their shares to the acquirer at the same price as the controlling shareholder, equally sharing the control premium.

3. *Tender Offer System Does not Ensure Equal Share of Control Premium*

The SD Inc. case is an ideal one in which all shareholders (including the controlling shareholder), through two sets of tender offer, received the same consideration per share, even where there was no regulation forcing such treatment. In other cases, however, due to lack of regulation of the tender offer price, the acquirer may pay less and less as the acquisition progresses. The acquirer may secure a toehold block without a tender offer, then launch a split set of tender offers with the price decreasing; as a whole, this will allow a distorted takeover structure.

An illustration of a fictional case demonstrates the problem:[22] Suppose an acquirer estimates the target's value at $85 per share. For a successful tender offer, the offer price should be $85 or more. Instead of a tender offer directed to all shareholders, the acquirer contacts the controlling shareholders and purchases 40% of the shares at $100 per share. After the toehold acquisition, the acquirer may make a tender offer at $80 and succeed as the remaining shareholders do not have any choice other than tendering their shares at that price. The acquirer may even split the tender offer into several offers with descending prices, reducing the overall payment.

That case is not just hypothetical in Korea. As toehold acquisition without a tender offer is permitted and no minimum price is imposed on the tender offer price, the acquirer and controlling shareholder may easily avoid sharing the control premium with minority shareholders. Even if a tender offer is made in a takeover situation, the minority shareholders do not always get the control premium like the controlling shareholders.

V. Mandatory Tender Offer Rule

One might argue that there is no reason to share the control premium with all shareholders; that is a controversial issue which will not be addressed in this chapter. If there are remedies to protect minority shareholders and uphold corporate governance in the takeover context, we need not raise concern about whether minority shareholders are maltreated. On the other hand, a lack of viable remedies would call for compulsory sharing of the control premium among all shareholders.

1. Hyundai Securities Co. Case

A recent case shows the conflict between the controlling shareholders and the remaining shareholders in a takeover context.

a) Phase I: Toehold Acquisition

In 2016, KB Financial Group agreed to purchase a controlling block of shares in Hyundai Securities Co. from Hyundai Merchant Marine, its largest shareholder, and five family members. As the number of sellers did not exceed 10, the deal was consummated through privately negotiated transactions without triggering the tender offer requirements. As a result, KB Financial Group acquired 22.56% of the target shares at 1.25 trillion Won in total (23,417 Won per share) in May 2016.

b) Phase II: Treasury Share Deal

Immediately after securing control of 22.56% of the shares through the private deal, KB Financial Group tried to purchase more shares in Hyundai Se-

[22] The following hypothetical example is based on BEBCHUK, *supra* note 16, 1788–1790.

curities to facilitate the next step of acquisition (the ultimate goal is to have Hyundai Securities 100% held by KB Financial Holding Co). KB Financial Group did not utilize a tender offer for that purpose; instead, KB Financial Group bought its treasury stock of 7.06% from Hyundai Securities at 6,410 Won per share, based on the market price at the time.

The remaining shareholders of Hyundai Securities became outraged: they alleged that the acquisition had been deliberately split into two phases to increase the amount of the control premium to Hyundai Merchant Marine and family members. They asserted that, because both of the two phases were negotiated as a whole structure, the purchase price for phase I and phase II should be the same, allocating the control premium evenly. Several minority shareholders filed a derivative suit against the board members of Hyundai Securities, blaming them for inflicting harm on the company by selling treasury stock at a price much lower than the price paid to controlling shareholders. If the treasury stock was sold at a premium, it would let the minority shareholders enjoy some of the control premium even without a tender offer.

c) Phase III: Stock Swap and Thwarting of Derivative Suit

In October 2016, KB Financial Holding Co enforced a stock swap of Hyundai Securities shares with its newly issued shares, making Hyundai Securities a 100% subsidiary. Its shareholding of 29.64% (including the purchased treasury stock) made it easy to obtain the relevant shareholders' approval. Dissenting shareholders were given 6,737 Won per share upon the exercise of their appraisal right, calculated based on the market price at the time.

Upon the consummation of the stock swap, all Hyundai Securities shares held by minority shareholders were changed into shares in KB Financial Holding. As the plaintiffs ceased to hold any shares in Hyundai Securities, the derivative lawsuit filed in Phase II was dismissed by the district court (the contestation of this dismissal is pending in the Supreme Court). If such a derivative suit is not permitted, there is no remedy available to secure any control premium for the minority shareholders of Hyundai Securities.

2. Fiduciary Duties: Enforcement?

Board members cannot be relieved of their fiduciary duties in a takeover context, whether hostile or friendly. This paper will not ponder the merit of the Hyundai Securities case, but there must at least be a remedy available if minority shareholders allege a breach of fiduciary duties by the board in connection with the takeover transaction. The derivative suit is designed as the remedy given to minority shareholders to ensure board members' fiduciary duties. However, in the Hyundai Securities case, the strong control acquired without due payment to minority shareholders enabled the stock swap to nullify the last resort of minority shareholders.

Korean courts have been robust in thwarting derivative suits which lack standing, yet there is still a possibility that the Supreme Court will issue a stunning decision in the Hyundai Securities lawsuit. Without such a miracle, fiduciary duties in the takeover context are just an empty phrase lacking any enforcement tools.

3. *Mandatory Tender Offer*

As seen above, the current Korean takeover laws fail to provide for a safety mechanism against expropriation by management and controlling shareholders in the takeover context. There might be more than one way to solve this issue: requiring more stringent fiduciary duties in the takeover context, as in the United States,[23] is one option; another is imposing the compulsory sharing of the control premium with minority shareholders through a mandatory tender offer rule, as in most EU member states and Japan.

Korea had a limited version of a mandatory tender offer rule from 1997 to 1998. According to the mandatory tender offer rule, anyone who wished to hold 25% of more of the outstanding voting shares of a listed company had to acquire target shares up to 50% + 1 share through a tender offer.[24] Such a mandatory tender offer was in effect for only one year; it was abolished in February 1998[25] after accusations that it had blocked the sale of distressed firms during the 1997 financial crisis.[26]

The re-introduction of the mandatory tender offer rule was recommended to the Ministry of Justice as part of the Financial and Corporate Restructuring Assistance Project,[27] which had been ignored for decades. Following more cases of conflicts between controlling shareholders and minority shareholders in takeover situations in which minority shareholders' interests were not attended to, more and more voices from both inside and outside of Korea have advocated for the necessity of a mandatory tender offer rule.[28]

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[23] S. J. Choi, The Future Direction of Takeover Law in Korea, Journal of Korean Law 7 (2007) 27–30.

[24] Art. 21 para. 5 Korea Securities and Exchange Act, Law No. 972/1962, as amended by Law No. 5254/1997.

[25] By amendment to Korea Securities and Exchange Law, Law No. 5521/1998.

[26] H.-J. Kim, *supra* note 2, 236.

[27] B. Black/B. Metzger/T. J. O'Brien, Y. M. Shin, Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness – Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea, Journal of Corporation Law 26 (2001) 605.

[28] E.-J. Lee, *Uimoo Kongaimaisu Jeanjedo Doip-e-tarun Sosujujudl-ui Bu Jungdaihyogwa* [Increase of Minority Shareholders' Wealth by Adoption of Mandatory Tender Offer Rule], Issue and Bunsock, Economic Reform Research Institute, 15 February 2017. S. J. Choi, *supra* note 23, suggested expansion of fiduciary duties, increasing shareholder liti-

The fear of unduly creating obstacles to takeover deals – the main reason for the abolition of the previous mandatory tender offer rule – should be dwarfed by the proliferation of takeovers economically ineffective which the current regulations failed to prevent from happening. Without a mandatory tender offer rule or leeway for structuring the acquisition, Korean controlling shareholders tend to extract as much as possible from their control in Korean companies with relatively low shareholdings. A recent study shows that, with a mandatory tender offer rule, minority shareholders' wealth would have been increased 139.9% for the recent four big takeover transactions, including the Hyundai Securities case.[29]

VI. Conclusion

The mandatory bid rule is a sound mechanism for preventing controlling shareholders' expropriation from minority shareholders in takeover situations.[30] If Korea had established reliable protections against such a danger, the Korean corporate control market would work efficiently without a mandatory tender offer rule. However, Korean takeover laws leave a takeover completed without offering equal opportunity to minority shareholders (as seen in Section III); Korean tender offer rules do not guarantee payment of a suitable control premium to minority shareholders (as seen in Section IV); and breaches of fiduciary duties by the board members, not to mention expropriation by the controlling shareholders, in the takeover context cannot be handled properly due to defective remedies. The statistics for the Korean takeover market show that hostile takeovers are rarely attempted and most share transfer transactions are privately done without the launch of a tender offer. In this situation, without having to give fair consideration to the minority shareholders, the controlling shareholders of Korean companies may receive more as a control premium, while the acquirer may purchase the control by paying less than the fair price. The execution of these distorted transactions would be significantly reduced with a mandatory tender offer rule ensuring payment of a fair premium to minority shareholders.

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gation and adoption of mandatory bid to prevent agency problems by controlling shareholders, or *Chaebols,* in Korean takeover law.

[29] E.-J. LEE, *supra* note 28, 2.

[30] J. A. MCCAHERY/L. RENNEBOOG, The Economics of the Proposed European Takeover Directive, CEPS Research Report in Finance and Banking, 32 (2003) iii.

Anti-Takeover Defensive Measures in Japan

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I. Introduction

In the mid-2000s, corporate Japan fell under the shadow of what seemed to be an impending wave of hostile takeovers.[1] Individual firms confronted with hostile takeover attempts responded by using both old indigenous techniques and new legal technology inspired by the US poison pill. This Chapter offers a concise account of the legal regime on the "defensive measures" that Japanese corporations may employ against hostile takeovers. Section II begins by describing the US poison pill, which is the most well-known and effective anti-takeover defense known to corporate law. Section III describes the legal design of Japan's defensive measures, which include old domestic legal mechanisms and the relatively new, US poison pill-inspired pre-warning

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[1] D. W. PUCHNIAK/M. NAKAIGASHI, The Enigma of Hostile Takeovers in Japan: Bidder Beware, Berkeley Business Law Journal 15 (2018) 13–15.

rights plans ("PRPs") that are today the most popular defensive measure in Japan. In Section IV, we discuss how two aspects of Japan's corporate landscape pose additional barriers to hostile takeovers. We round off the Chapter with a brief summary.

II. The US Poison Pill: A Brief Primer

Hostile takeovers were a major phenomenon in US corporate law. The US-style "poison pill" was developed in 1982 by Martin Lipton, a New York attorney, as a legal mechanism to be adopted by the board of a corporation in the event of an unsolicited takeover bid. Lipton conceptualized the pill's purpose as affording the board additional time to devise a response to the takeover bid that would "maximize shareholder value".[2] Most modern poison pills are designed around corporate "rights" that are triggered when a hostile acquirer reaches a certain ownership threshold (typically from 10 to 20 percent) in the target corporation. When triggered, the target's shareholders – except the acquirer – are eligible to acquire additional shares on favorable terms, which when exercised would result in the dilution of the acquirer's shareholding.[3] A major attraction of the poison pill was the fact that the board could adopt one without the need for shareholder approval.[4] Withstanding repeated judicial scrutiny by the Delaware Supreme Court in a series of cases in the 1980s,[5] the poison pill gave every board the power to "just say no" to a hostile bid.[6]

Whether it is right for corporate boards to be able to "just say no" to a takeover bid is a question long-debated by scholars,[7] but the poison pill makes it clear that corporate managers have the final say, not shareholders.[8] As a leading

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[2] M. LIPTON, Pills, Polls, and Professors Redux, The University of Chicago Law Review 69 (2002) 1043–1044.

[3] P. DAVIES/K. HOPT/W.-G. RINGE, Control Transactions, in: Kraakman et al. (eds.), The Anatomy of Corporate Law: A Comparative and Functional Approach (3rd. ed., Oxford 2017) 216.

[4] M. KAHAN/E. B. ROCK, How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law, The University of Chicago Law Review 69 (2002) 909.

[5] *Smith v. Van Gorkom,* 488 A2.d 858 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews and Forbes Holdings,* 506 A.2d 173 (Del. 1986); *Moran v. Household International, Inc.,* 500 A.2d 1346 (Del. 1985); *Paramount Communications, Inc. v. Time, Inc.,* 571 A.2d 1140 (Del. 1989).

[6] M. KAHAN, Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence, Journal of Corporation Law 19 (1994) 604; J. N. GORDON, Corporations, Markets, and Courts, Columbia Law Review 91 (1991) 1941, 1944–1947.

[7] C.f. L. A. BEBCHUK, The Case Against Board Veto in Corporate Takeovers, The University of Chicago Law Review 69 (2002) 973; LIPTON, *supra* note 2.

[8] L. A. BEBCHUK/A. FERRELL, Federalism and Corporate Law: The Race to Protect Managers from Takeovers, Columbia Law Review 99 (1999) 1189; F. PARTNOY and S.

American scholar put it: "The takeover wars are over. Management won."[9] A majority of S&P 1500 companies in the 1990s had poison pills in place,[10] and every hostile acquisition targeting a US corporation had to confront one.[11] The poison pill is at least partly responsible[12] for the fall and subsequent stagnation of hostile acquisitions over the 1980s and 1990s.[13] "Friendly", negotiated acquisitions also became the norm in the US M&A market.[14]

In response, scholars sympathetic to the shareholders' cause,[15] proxy advisory firms,[16] and activist shareholders[17] soon began calling for poison pills to be limited or abolished. Traditional anti-takeover poison pills became increasingly unpopular,[18] and only sixty-five companies in the S&P 1500, or about 4 percent, maintained a poison pill in 2017, a stark decrease from 2005 (when the figure was 54 percent).[19] However, that does not mean boards are

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DAVIDOFF SOLOMON, Frank and Steven's Excellent Corporate-Raiding Adventure, The Atlantic, May 2017, <https://www.theatlantic.com/magazine/archive/2017/05/frank-and-stevens-excellent-corporate-raiding-adventure/521436/>.

[9] J. A. GRUNDFEST, Just Vote No: A Minimalist Strategy for Dealing with Barbarians inside the Gates, Stanford Law Review 45 (1993) 858.

[10] J. C. COATES IV, Explaining Variation in Takeover Defenses: Blame the Lawyers, California Law Review 89 (2001) 1307.

[11] L. A. BEBCHUK / J. C. COATES IV / G. SUBRAMANIAN, The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, Stanford Law Review 54 (2002) 926–927.

[12] GORDON, *supra* note 6, 1931–1932; R. W. HAMILTON, Corporate Governance in America 1950–2000: Major Changes but Uncertain Benefits, Journal of Corporation Law 25 (2000) 358.

[13] KAHAN / ROCK, *supra* note 4, 879 n. 33; J. H. FLOM, Mergers & Acquisitions: The Decade in Review, University of Miami Law Review 54 (2000) 761–762.

[14] HAMILTON, *supra* note 12, 358; see also KAHAN / ROCK, *supra* note 4, 880–881 (noting that the line between friendly and hostile acquisitions had blurred).

[15] See e.g. R. J. GILSON, Unocal Fifteen Years Later (And What We Can Do About It), The Delaware Journal of Corporate Law 26 (2001) 512; BEBCHUK, *supra* note 7, 1035.

[16] F. J. AQUILA, Adopting a Poison Pill in Response to Shareholder Activism, Practical Law, April 2016, 24–25, <https://www.sullcrom.com/files/upload/Apr16_InTheBoardroom.pdf>; ISS (Institutional Shareholder Services), United States Proxy Voting Guidelines: Benchmark Policy Recommendations, 4 January 2018, 26, <https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf>.

[17] J. HALL, Hostile takeovers hit record as market swoons, Reuters, 29 September 2008, <https://www.reuters.com/article/us-mergers-hostiles/hostile-takeovers-hit-record-as-market-swoons-idUSTRE48S2P120080929>.

[18] M. TONELLO, Poison Pills in 2011, Harvard Law School Forum on Corporate Governance and Financial Regulation, 3 April 2011, <https://corpgov.law.harvard.edu/2011/04/03/poison-pills-in-2011/> (observing that the number of corporations with poison pills fell from more than 2,200 in 2001 to fewer than 900 in 2011).

[19] K. PAPADOPOULOS et al., U.S. Board Study: Board Accountability Practices Review, Institutional Shareholder Services, 1 April 2018, 13, <https://www.issgovernance.com/file/publications/board-accountability-practices-review-2018.pdf>.

now powerless to repel hostile acquirers. So long as boards can adopt poison pills whenever they need to, they can enjoy the poison pill's benefits through the "shadow pill" effect, even without an "active" poison pill in place.[20] The poison pill, therefore, has ever since its appearance been a constant, distinctive, and influential feature of US corporate governance.

It should not surprise then that one of the most important legal mechanisms in modern American corporate governance would be eventually transplanted into what remains today the world's third largest economy[21] and fourth largest stock market[22] – Japan. Although not legally binding legislation, the Takeover Guidelines released in 2005[23] communicated the Japanese government's approval of defensive measures modelled on the Delaware poison pill in a move hailed by American pundits as an epochal moment in corporate governance.[24] Within a few years of the Takeover Guidelines' release, a "poison pill" was quickly adopted by hundreds of Japanese listed companies.[25]

In the next Section, we discuss the various options available to Japanese boards faced with the challenge of a hostile takeover.

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[20] J. C COATES IV, Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence, Texas Law Review 79 (2000) 286–291; F. J. AQUILA/M. SAWYER, Poison Pills Find New Life as "Raider-Like" Activism is on the Rise, Business Law Today, September 2014, <https://www.americanbar.org/content/dam/aba/publications/blt/2014/09/keeping-current-sawyer-201409.authcheckdam.pdf>.

[21] As of October 2018, in nominal terms, after the United States and the People's Republic of China. International Monetary Fund, World Economic Outlook (October 2018) – GDP, current prices, IMF DataMapper, 2018, <https://www.imf.org/external/datamapper/NGDPD@WEO/OEMDC/ADVEC/WEOWORLD/JPN>.

[22] As of April 2017, and after the New York Stock Exchange, NASDAQ, and the London Stock Exchange: statista, Largest world exchanges by equity capitalization 2017, The Statistics Portal 2017, <https://www.statista.com/statistics/264661/domestic-market-capitalization-worldwide-top-10/>.

[23] Ministry of Economy, Trade and Industry and Ministry of Justice, Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests, 27 May 2005, <http://www.meti.go.jp/policy/economy/keiei_innovation/keizaihousei/pdf/shishin_hontai.pdf> [hereinafter Takeover Guidelines].

[24] C. J. MILHAUPT, In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan, Columbia Law Review 105 (2005) 2216.

[25] Y. FUJISHIMA, *Baishū Bōeisaku wo meguru Kinji no Dōkō* (買収防衛策を巡る近時の動向) [Recent Trends in Defensive Measures], Daiwa Institute of Research, Consulting Report, 20 February 2009, 2 tbl 1, <https://www.dir.co.jp/report/research/capital-mkt/esg/09022001cg.pdf>.

III. Anti-Takeover Defensive Measures in Japan: A Typology

Although some commentators use the term "poison pill" freely in the Japanese context,[26] in the interests of precision and fidelity we use the term "defensive measures" in this section when referring to *Japanese* anti-takeover defenses in general. We use "poison pill" without quotation marks or qualification only when referring to the US anti-takeover defenses; references to a "poison pill" or to a "pill" qualified with "so-called" or inverted commas are to Japan's "defensive measures".

Our discussion tracks the classification used in Japanese legal literature, which divides defensive measures into two categories: *ex-post* measures (Section III.1) and *ex-ante* measures (Section III.2).[27]

1. Ex-Post Measures

Ex-post measures refer to defenses implemented only after a hostile takeover attempt is impending or has already begun. They comprise (1) share or share option[28] placements,[29] which is the issue of shares or share options to a specific party that supports incumbent management; or (2) option allotments, which is an issue of share options to all shareholders that are exercisable by all shareholders except the hostile acquirer. Option allotment is functionally similar to a US poison pill that is implemented *ex post* – i.e. when a takeover attempt is underway. Aspiring hostile acquirers have challenged both, with mixed success, in court.

Shareholders who suffer or are likely to suffer prejudice from improper use of share placements and option allotments are granted protections under Japanese corporate law. An injunction restraining a share placement may be granted by the court on the following grounds: (1) unlawfulness or (2) an "extremely unfair" method of placement.[30] Most shareholder plaintiffs proceed under the second prong, which is also the statutory basis for the judicially developed "primary purpose rule". According to this doctrine, a placement whose "primary purpose" is for management to retain control of the corpora-

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[26] E.g. GILSON, *supra* note 24; Z. SHISHIDO, Introduction: The Incentive Bargain of the Firm and Enterprise Law: A Nexus of Contracts, Markets, and Laws, in: Shishido (ed.), Enterprise Law: Contracts, Markets, and Laws in the US and Japan (Cheltenham 2014).

[27] For the overall regulatory framework on hostile takeovers and detailed exposition on critical cases and materials, see PUCHNIAK/NAKAHIGASHI, *supra* note 1, 6, 22–38.

[28] Share options are also sometimes called "warrants".

[29] Sometimes also known as "issuances" or "allotments".

[30] Companies Act, § 210 (shares), § 247 (share options).

tion may be restrained by injunction.[31] However, it is well known that the courts are unlikely to find an improper purpose for a placement where some other seemingly legitimate reason to raise capital is offered as the reason for the placement.[32] Hence, to survive a court challenge, it is usually easy and sufficient for a target corporation's board to say that there was a need to raise capital.[33] The board's discretion over how capital should be raised will be respected provided the court finds that the corporation needed to raise funds.[34] The issuance of a share placement to a pro-management shareholder to frustrate a takeover attempt has therefore been difficult to challenge under the "primary purpose rule" – at least until relatively recently.[35]

For option placements, the leading case is *Livedoor* (2005).[36] Led by the controversial Takafumi Horie, Livedoor commenced a hostile takeover attempt against the broadcaster Nippon Broadcasting System ("NBS"). In response, the management of NBS announced a plan to place share options to a friendly shareholder that would dilute Livedoor's NBS shareholding substantially if exercised. Livedoor applied for an injunction restraining NBS from proceeding with the option placement. It is important to note that NBS did not attempt – and would have found it impossible – to argue that the allotment's "primary purpose" was not to entrench existing management but to raise funds.[37] The Tokyo District Court granted the requested injunction, and the Tokyo High Court affirmed the first instance decision.[38] There was, however, a jurisprudential development in the form of an exception to the "primary purpose rule". The Tokyo High Court recognized four situations in which the target corporation's shareholders' interests are so clearly harmed that a share or share option placement by the target board for the "primary purpose" of retaining control of the corporation to protect shareholders' interests is permitted. They are: (1) instances of greenmail;[39] (2) where the acquirer takes control of the target corporation and operates it temporarily for the purpose of

[31] See generally K. EGASHIRA, *Kabushiki Kaisha-hō* (株式会社法) [The Laws of Stock Corporations (title as translated by source author)] (7th ed., Tōkyō 2017) 773–775; PUCHNIAK/NAKAHIGASHI, *supra* note 1, 28–33.

[32] EGASHIRA, *supra* note 31, 773.

[33] T. FUJITA, Case No. 29: Corporate Law – Takeovers – Issuance of Share Options as Defence Measure – Principal Purpose Rule, in: Bälz et al. (eds.), Business Law In Japan: Cases and Comments (Alphen aan den Rijn 2012) 317–318; PUCHNIAK/NAKAHIGASHI, *supra* note 1, 29.

[34] EGASHIRA, *supra* note 31, 773.

[35] See discussion and cases cited in EGASHIRA, *supra* note 31, 773–774.

[36] For details, see PUCHNIAK/NAKAHIGASHI, *supra* note 1, 30–33.

[37] FUJITA, *supra* note 33, 318.n9.

[38] Tōkyō High Court, 23 March 2005, Hanta 1173, 125.

[39] Where the bidder acquires shares intending to force the target corporation to buy them back at a premium.

benefiting itself to the detriment of the target;[40] (3) where the acquirer uses assets of the target as collateral for or to repay the obligations of the acquirer or its associates; and (4) where the acquirer causes the target to divest of valuable assets and distributes the proceeds to the shareholders, sells off the target shares at a temporarily inflated price, or both.[41]

The Takeover Guidelines, a document issued jointly by two government ministries in 2005 as a non-legally-binding[42] code of conduct for business,[43] incorporated the jurisprudential advancements in *Livedoor.*[44] The Guidelines make it clear that "it is legitimate and reasonable for a joint-stock corporation to adopt defensive measures designed to protect and enhance shareholder interests by preventing certain shareholders from acquiring a controlling stake in the corporation",[45] and thereby granted defensive measures the recognition of the Japanese establishment.

A later landmark case – which reached the Supreme Court – is *Bull-Dog Sauce* (2007).[46] Steel Partners, a US private equity fund, launched a bid for all outstanding shares of Bull-Dog Sauce Co. Ltd.[47] Bull-Dog Sauce's board responded with a proposal under which all existing shareholders would be allotted three share options per share. Steel Partners would not be permitted to exercise the allotted options, but if other shareholders were to exercise their options, Steel Partners would be entitled to receive 396 yen per share, or over 2 billion yen in total. Bull-Dog Sauce's defensive measure was thus structured to pay Steel Partners off in exchange for diluting its shareholding, a decision that was taken in light of pre-existing jurisprudence.[48] The board's

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[40] For example, for the bidder to acquire the target corporation's key assets at undervalue.

[41] PUCHNIAK/NAKAHIGASHI, *supra* note 1, 33; FUJITA, *supra* note 33, 315, 319; Corporate Value Study Group, Corporate Value Report, 25 May 2005, 33 n. 57, <http://www.meti.go.jp/policy/economy/keiei_innovation/keizaihousei/pdf/houkokusyo_hontai_eng.pdf>.

[42] Takeover Guidelines, *supra* note 23, 3.

[43] *Id.* at 3 ("The mission of the Guidelines is to change the business community from one without rules concerning takeovers to one governed by fair rules applicable to all. To prepare for the upcoming era of M&A activity, we expect the Guidelines to become the code of conduct for the business community in Japan by being respected and, as the need arises, revised.").

[44] *Id.* at 4 note 1.

[45] *Id.* at 4.

[46] Supreme Court, 7 August 2007, Minshū 61 2215. See H. ODA, Case No. 30: Corporate Law – Takeovers – Defensive Measures – Equality of Shareholders, in: Bälz et al. (eds.), *supra* note 33, 323.

[47] See generally C. J. MILHAUPT, Bull-Dog Sauce for the Japanese Soul? Courts, Corporations, and Communities – A Comment on Haley's View of Japanese Law, Washington University Global Studies Law Review 8 (2009) 353–356.

[48] See M. IWAKURA/G. ÔKAWA, *Burudoggu Baishū Bōeisaku Soshō – Baishu Bōeisaku de Hatsu no Saikōsai Kettei* (ブルドッグ買収防衛策訴訟―買収防衛策で初の最高裁決定)

proposal received shareholder approval, with 88.7 percent of the votes present at the shareholder meeting voting in favor. Steel Partners responded by applying for an injunction restraining the option allotment. The application was dismissed by the Tokyo District Court, and Steel Partners' appeals to the Tokyo High Court and the Supreme Court were dismissed. The Supreme Court took the position that shareholders of the target corporation have the right to decide if defensive measures should be adopted and that the target corporation's discriminatory treatment of the hostile bidder is justified as "fair and adequate measures" were taken to compensate the bidder.[49]

The *Bull-Dog Sauce* case understandably drew considerable attention,[50] but it is important to appreciate two unique aspects of the case that are unlikely to be repeated today. First, almost all target shareholders rallied in support of the board's response, which raises the question why the board even found it necessary to proceed with adopting the defensive measure in the first place. Second, the defensive measure in Bull-Dog involved a payout to the hostile bidder – a feature that has subsequently been discouraged by the establishment[51] and that is no longer found in newer versions of defensive measures.[52]

[Bull-Dog Defensive Measure Litigation: The First Supreme Court Decision on Defensive Measures], Hōgaku Seminā 638 (2008) 26, 27.

[49] See ODA, *supra* note 46, 326; PUCHNIAK / NAKAHIGASHI, *supra* note 1, 36–37.

[50] The leading commercial law periodical publisher in Japan dedicated a 442-page special issue collecting documents relevant to the case. See *Burudoggu Sōsu no Hō-teki Kentō: Baishū Bōeisaku ni kansuru Saiban Keika to Igi* (ブルドックソース事件の法的検討 - 買収防衛策に関する裁判経過と意義) [Legal Analysis of the Bull-Dog Sauce Case: The Judicial Proceedings on Anti-Takeover Defensive Measures and Their Significance], Editorial Board of Bessatsu Shōji Hōmu, Shōji Hōmu 311 (2007). The case is also discussed in MILHAUPT, *supra* note 47; H. KANDA, Takeover Defences and the Role of Law: A Japanese Perspective, in: Michel Tison et al. (eds.), Perspectives in Company Law and Financial Regulation (Cambridge 2009); J. G. HILL, Takeovers, Poison Pills and Protectionism in Comparative Corporate Governance, in: Grundmann et al. (eds.), Festschrift für Klaus J. Hopt (Berlin 2010) 808; N. RAYNE / R. MURAI, Japan's Bull-Dog OK's poison pill for Steel Partners, Reuters, 24 June 2007, <https://www.reuters.com/article/bulldog-steelpartners-idUST20535420070624>; A. TUDOR, Steel Partners presses on with Bull-Dog bid, Reuters, 8 August 2007, <https://www.reuters.com/article/us-steel-partners-bulldog/steel-partners-presses-on-with-bull-dog-bid-idUST26371820070808>; S.-C. J. CHEN, Japan High Court Keeps Bull-Dog Sauce From Steel Partners' Jaws, Forbes, 8 August 2007, <https://www.forbes.com/2007/08/08/bulldog-steel-partners-markets-equity-cx_jc_0808markets03.html>.

[51] Corporate Value Study Group, Takeover Defense Measures in Light of Recent Environmental Changes, 30 June 2008, 3–4, <https://web.archive.org/web/20080912190956/http://www.meti.go.jp/english/report/data/080630TakeoverDefenseMeasures.pdf>.

[52] M&A Hō Taikei (M&A法大系) [Comprehensive Analysis of M&A Laws in Japan (translated title in original)] 798 (森・濱田松本法律事務所), Mori Hamada & Matsumoto (ed.), (Tōkyō 2015).

2. Ex-Ante Measures: Pre-Warning Rights Plans – "PRPs"

Ex-ante measures became popular after the release of the Takeover Guidelines, which expressly referred to defensive measures adopted before a hostile bid is commenced.[53] Since then, *jizen keikoku gata bôeisaku* ["Pre-Warning Rights Plans"] ("PRPs") have been overwhelmingly the most popular type of defensive measure in Japan. Usually, a PRP is a statement by the board of a corporation, issued in the form of a press release, as to how it intends to respond to a hostile bid.[54] A bidder that intends to make an acquisition that would leave it in control of a particular percentage of shares (such as 20 percent) is required to make disclosures to the target board.[55] A failure to make the necessary disclosures or a determination by the board that the acquisition attempt would harm "corporate value" or the interests of the shareholders[56] constitutes grounds to trigger the PRP.

The exact procedure by which the PRP is triggered varies. The versions as adopted by some companies require only a board resolution; others a special (independent) committee recommendation and a board resolution; others call for shareholder approval.[57] As of 31 October 2018, a minority – less than 30 percent – of active PRPs have been designed so as to be triggered without shareholder involvement, i.e. by the board or a board committee.[58] Shareholder approval is expressly required in approximately 10 percent of the active PRPs; the remaining 60 percent or so contemplate a shareholder vote in certain circumstances.[59] A triggered PRP would result in an allotment of share options – which are not exercisable by the hostile acquirer (and associates) – to all shareholders.[60] Although a PRP may be adopted by a board resolution only,[61] some kind of shareholder involvement is the norm today.[62] PRPs also usually last for only one to three years – with three being the most common term[63] – and may be

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53 See Takeover Guidelines, *supra* note 23, 6.

54 J. ARMOUR et al., The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework, Harvard International Law Journal 52 (2011) 254 (making the perceptive observation that "[u]nlike the U.S. shareholder rights plan, the pre-warning rights plan is not a legal instrument").

55 M&A Laws, *supra* note 52, 797.

56 M&A Laws, *supra* note 52, 797–798; ARMOUR et al., *supra* note 54, 254; KANDA, *supra* note 50, 419.

57 M&A LAWS, *supra* note 52, 797; ARMOUR et al., *supra* note 54, 254 n.175; KANDA, *supra* note 50, 419 and 419.n16.

58 MARR, *M&A Tōkei (Hyō to Gurafu)* (M&A統計（表とグラフ）) [M&A Statistics: Tables and Graphs], December 2018, 33 (110 out of 383 PRPs).

59 *Id.* (39 and 234 of 383 PRPs, respectively).

60 M&A Laws, *supra* note 52, 798.

61 As contemplated in the Takeover Guideline*s, supra* note 23, 6.

62 KANDA, *supra* note 50, 419.

63 See MARR, *supra* note 58, 33.

abolished by the board before expiry or a renewed (with or without modification) upon expiry, usually with a shareholder vote.[64]

PRPs – or at least, an early version of them – failed the judicial test in *Nireco* (2005).[65] The Tokyo District Court issued an injunction that stopped the target from implementing the PRP[66] in a decision later upheld by the Tokyo High Court.[67] The *Nireco* PRP, however, was designed with a flaw: it harmed the interests of innocent shareholders, not just the hostile bidder.[68] The validity of modern PRPs that do not share the same flaw has yet to be tested in court and thus remains uncertain.

Defensive measures and their varieties notwithstanding, it is important to note that in spite of a considerable number of hostile takeover *attempts* over the years, none have ever succeeded.[69] Why? The law on Japan's defensive measures – or what little there is of it – cannot supply the answer to this question. We therefore turn to the broader context for explanations.

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64 M&A LAWS, *supra* note 52, 798.

65 See PUCHNIAK / NAKAHIGASHI, *supra* note 1, at 35.

66 Tōkyō District Court, 1 June 2005, Hanta 1186, 274; Tōkyō District Court, 9 June 2005, Hanta 1186, 265.

67 Tōkyō High Court, 1 June 2005, Hanta 1186, 254.

68 M&A Laws, *supra* note 52, 796.n67; ARMOUR et al., *supra* note 54, 259 n.150; FUJITA, *supra* note 33, 320. See also Takeover Guidelines, *supra* note 23, 2 n.10.

69 We define a successful hostile takeover as one where the bid would trigger the mandatory bid rule (*i.e.* at least two-thirds control of the corporation) and the acquirer replaces the incumbent senior management, including the board. This excludes management-initiated leveraged buyouts (MBOs) and partial offers in which the bidder intended only to secure a less than two-thirds stake in the corporation. It should also be noted that there is no single case that observers unanimously identify as a successful hostile takeover. For example, it has been claimed that there were two successful hostile takeovers. *Dōi-nai Baishū, Kabunushi Kyōkan Hirogaru-ka / Tekitai-teki TOB, Sukunau Seikōrei* (同意ない買収、株主共感広がるか　敵対的TOB、少ない成立例) [Acquisitions Without Consent – Gaining Shareholder Sympathy? The Few Successful Examples of Hostile Tender Offer Bids], Yahoo News Japan, 7 February 2019, <https://headlines.yahoo.co.jp/hl?a=20190207-00000081-mai-brf> (listing only SSP Co, Ltd and Solid Group Holdings as the only two successful takeovers). However, even these two exceptional examples do not fit our definition. The 2000 bid for SSP Co, Ltd was not opposed by the board (*i.e.* it was friendly), and the few instances of hostile acquisitions were not by an open bid but rather on-market purchases. K. FUJINAWA, *Tekitai-teki Baishū to Taikō-saku wo meguru Giron ni tsuite* (敵対的買収と対抗策を巡る議論について) [On the Debate Surrounding Hostile Acquisitions and Their Countermeasures], RIETI, 13 February 2006, <https://www.rieti.go.jp/jp/events/bbl/06021301.html>. The 2007 successful hostile bid for Solid Group Holdings (now CARCHS Holdings) by Ken Enterprise was not for all outstanding shares, but only up to 66.58 percent (under the two-thirds mandatory bid triggering threshold), and it succeeded only because Lehmann Brothers tendered its 48 percent. See *Ken Entāpurazu no Soriddo Gurūpu HD e no Tekitai-teki TOB Seiritsu* (ケン・エンタープライズのソリッドグループHDへの敵対的TOB成立) [Ken Enterprise's Hostile Tender Offer Bid for Solid Group Holdings Succeeds], Reuters Japan, 13 December 2007, <https://jp.reuters.com/article/idJPJAPAN-29348620071213>.

IV. Contextual Factors Impeding Hostile Takeovers in Japan

Hostile takeovers are associated with dispersed shareholding – a relatively rare phenomenon, globally speaking.[70] Japan's unusual status as a highly-dispersed equity market has long been noted by scholars.[71] A further distinctive feature of listed corporations in Japan has been the abundance of targets seemingly ripe for takeovers, with bust-up values often exceeding market capitalization.[72] Combined with low price-to-book values, Japan would appear ripe for hostile acquirers.[73] And try they did – to little avail. We suggest that even without defensive measures – or at least verifiably legally effective ones – two aspects of Japan's unique corporate landscape are responsible for the failure of hostile takeover attempts.

First, Japanese corporations may have dispersed shareholders, but some dispersed shareholders are different from others. "Stable shareholders", who are corporate insiders with existing commercial relationships with the corporation, do not usually act against the interests of incumbent management.[74] In fact, stable shareholders can and have come to the aid of incumbent management in the face of hostile takeover attempts[75] – the *Livedoor* and *Bull-Dog Sauce* cases are good examples of this.[76] The sympathy stable shareholders have for management – and the antipathy they have for hostile acquirers – even motivate decisions that cause financial detriment to themselves.[77] Although the shareholding structure in large public corporations has shifted away from stable shareholders and towards foreign institutional investors in recent years,[78] small and medium-sized listed corporations – which activist

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[70] ARMOUR et al., *supra* note 54, at 221–222.

[71] See PUCHNIAK/NAKAHIGASHI, *supra* note 1, 5 fn. 2.

[72] See PUCHNIAK/NAKAHIGASHI, *supra* note 1, 5–6, 13–14.

[73] See PUCHNIAK/NAKAHIGASHI, *supra* note 1, 8 ("hostile takeovers utopia").

[74] R. J. GILSON, Reflections in a Distant Mirror: Japanese Corporate Governance Through American Eyes, Columbia Business Law Review (1998) 209 n. 19 (a "stable shareholder" is one who "agrees not to sell the shares to third parties unsympathetic to incumbent management, particularly hostile takeover bidders or bidders trying to accumulate strategic parcels of shares [and who] agrees, in the event that disposal of the shares is necessary, to consult the firm or at least give notice of its intention to sell"); see also PUCHNIAK/NAKAHIGASHI, *supra* note 1, 17.

[75] See PUCHNIAK/NAKAHIGASHI, *supra* note 1, 17–19.

[76] Discussed above at III.1.

[77] G. GOTO, Legally "Strong" Shareholders of Japan, Michigan Journal of Private Equity & Venture Capital 3 (2014) 125 (discussing *Bull-Dog Sauce*).

[78] GOTO, *supra* note 77, 145–146; see also M. HIDEAKI/N. KEISUKE, *Kabushiki shoyū kōzō no tayōka to sono kiketsu – Kabushiki mochiai no kaishō/"fukkatsu" to kaigai tōshika no yakuwari* (株式所有構造の多様化とその帰結―株式持ち合いの解消・「復活」と海外投資家の役割) [Diversification of Share-Ownership Structure and its Consequences/Unwinding and "Revival" of Cross-Shareholdings and the Role of Foreign Investors], in:

shareholders prefer to target – retain high shareholding levels by stable shareholders and low foreign ownership.[79] Japanese investors who are not stable shareholders are also generally patient with incumbent management,[80] and even foreign investors have been reluctant to rock the boat.[81] For Japanese firms, the shared antipathy towards hostile takeovers between management and stable shareholders[82] creates – even without defensive measures based on corporate law – a form of defense against hostile takeovers. In this sense, the corporate culture in Japan[83] prevents the dispersed nature of shareholding in its firms from becoming a vulnerability.

Second, Japanese firms' boards (at least historically)[84] and senior managers are dominated by lifetime employees. Lifetime employees, who remain a feature despite macro-level changes in the Japanese economy,[85] have strong incentives – both financial and non-financial – not to lose control of the firms they work for to external parties, which in turn has impeded hostile takeovers.[86]

Together, aspects of the broader context in which hostile takeovers (if any) must operate explain why hostile takeovers were unlikely to and did not in fact succeed, regardless of whether effective defensive measures of a legal nature were available. That is not to say, however, that hostile takeovers can never succeed, or that PRPs are unnecessary. Unless Japan evolves into a concentrated shareholding or state-dominated equity market, a key precondition for hostile takeovers – dispersed shareholding – will always be present.

Hideaki (ed.), Nihon no Kigyō Tōchi (日本の企業統治) [Corporate Governance in Japan] (Tōkyō 2011) 135.

79 See GOTO, *supra* note 77, 146.

80 GOTO, *supra* note 77, 142–143; J. BUCHANAN et al., Unexpected Corporate Outcomes from Hedge Fund Activism in Japan, Socio-Economic Review (forthcoming) 15 (2018).

81 J. BUCHANAN et al., Hedge Fund Activism in Japan: The Limits of Shareholder Primacy, 2012, 213–224; M. MARRIAGE, Foreign Investors Fear Holding Japan Inc to Account, Financial Times, 9 January 2016, <https://www.ft.com/content/080fd530-a7fe-11e5-9700-2b669a5aeb83>.

82 C. J. MILHAUPT, Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance, University of Pennsylvania Law Review 149 (2001) 2100.

83 See PUCHNIAK/NAKAHIGASHI, *supra* note 1, 41.

84 S. N. KAPLAN, Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States, Journal of Political Economy 102 (1994) 517, 520; D. W. PUCHNIAK, Why Investor Trust (and Not the Law) Matters: Japanese Lifetime Employment's Role as a Non-Legal Mechanism for Credible Investor Trust (LL.D. dissertation chapter, 2008) 15, <DOI:10.2139/ssrn.2318953>. See also Tokyo Exchange Inc, TSE-Listed Companies White Paper on Corporate Governance 2017, March 2017, 75, chart 57, <https://www.jpx.co.jp/english/equities/listing/cg/tvdivq0000008jb0-att/b5b4pj000001nj2x.pdf>.

85 See S. A. SHIMODA, Time to Retire: Is Lifetime Employment in Japan Still Viable?, Fordham International Law Journal 39 (2016) 753.

86 See PUCHNIAK/NAKAHIGASHI, *supra* note 1, 38–41.

Stable shareholders may abandon smaller listed firms; lifetime employment may eventually vanish. So long as there is money to be made in hostile takeovers, the incentive for someone to try will not go away. And so long as the specter of hostile takeovers remains present,[87] defensive measures may decline but never disappear completely from legal imagination.

V. Summary

1. This Chapter provides an overview of the law on legal defensive measures available to the management of Japanese corporations facing hostile takeover attempts.
2. The US poison pill, which we describe in Section II, offered management of US firms a powerful defense against hostile takeovers and inspired Japan's most popular defensive measure, the PRP.
3. An array of defensive measures, comprising *ex-post* (Section III.1) and *ex-ante* (Section III.2) varieties, are available under Japanese law; their legal effectiveness, as jurisprudence shows, varies.
4. The implementation (i.e. adoption and triggering) of the most popular type of defensive measure today, the PRP, varies considerably in practice (a concise account of which is offered in Section III.2).
5. Beyond the law and practice of defensive measures, unique features of Japan's corporate landscape, such as stable shareholder support and lifetime employees in senior management, also impede hostile takeovers – at least until the time of writing (Section IV).

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[87] As of February 2019, there is an ongoing hostile bid by Itochu Corporation for Descente, but the bid is for only 40 percent and thus not a hostile takeover under our definition (*supra* note 69). See L. DU/L. NONOMIYA, A Rare Hostile Takeover Bid in Japan Signals Changing Times, Bloomberg, 7 February 2019, <https://www.bloomberg.com/news/articles/2019-02-07/a-rare-hostile-takeover-bid-in-japan-signals-changing-times>.

Hostile Takeovers in China

Recent Developments and Regulatory Challenges

*Robin Hui Huang/Juan Chen/Pin Lyu**

I. Introduction

Although the Chinese securities market was established in the early 1990s and has since grown rapidly, hostile takeovers did not attract much attention until recently. In the last few years, a combination of relevant factors, including the weak stock market, ample funds for takeover transactions, and the less concentrated shareholding structure of Chinese listed companies, has provided an environment conducive to hostile takeovers. Hostile takeovers are on the rise, as is the use of takeover defenses. The recent high-profile case of

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Vanke vs. Baoneng, for example, has generated intensive public debate on the use and regulation of takeover defenses in China.[1]

Internationally, different jurisdictions have adopted different laws on the issue of takeover defenses. Naturally, each regulatory model has its advantages and disadvantages, and the efficacy of any law depends very much on the particular context in which it operates. Drawing upon international experiences, China has had a formally established legal regime for takeover defenses since 2002. How has China transplanted foreign laws in relation to takeover defenses? Are they properly adapted to Chinese local conditions? Have they been effectively enforced in practice? How will the legal regime likely develop in future? This paper aims to shed light on these questions, examining both the law on the books and the law in action for takeover defenses in China.

II. Legal Framework

1. The Regulator

The China Securities Regulatory Commission (CSRC) is the national securities regulator, with centralized power to oversee China's securities market, and hence has jurisdiction over takeovers of listed companies. In 2006, the CSRC set up a specialised committee known as the M&A and Restructuring Examination Committee *(Binggou Chongzu Shenhe Weiyuanhui)* to handle takeover-related matters, including the use of takeover defenses. This committee is mainly composed of relevant professionals and experts who are appointed on a part-time basis, and its function is to provide opinions about takeover regulation for the CSRC.

In short, as a technocratic entity, the CSRC is assigned a virtually exclusive dispute resolution role with respect to takeovers. It should be noted, however, that in recent years, the CSRC has been gradually reducing administrative interventions in takeover activities by partly eliminating administrative approval requirements and partly transferring some regulatory powers to the stock exchanges.

2. Key Provisions

Due to the broad nature and wide variety of takeover defenses, the legal provisions governing takeover defenses can be found in several laws as well as a few

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[1] T. MITCHELL/B. BLAND, Vanke tussle points to China's first hostile takeover battle, Financial Times, 28 December 2015; "China Vanke drops white knight rail deal", Financial Times, 19 December 2016; "Baoneng Backs off from Fight over Vanke's Control", Cai Xin, 14 January 2017; "Vanke sues over 'invalid' Baoneng stake", South China Morning Post, 8 February 2017; "Shenzhen Metro to become biggest China Vanke shareholder as Evergrande cashes out", South China Morning Post, 9 June 2017.

administrative rules promulgated by the CSRC. These include, amongst others, the 2005 *Zhonghua Renmin Gongheguo Zhenquan Fa* (Securities Law of the People's Republic of China, hereinafter: 2005 Securities Law),[2] the 2006 *Shangshi Gongsi Shougou Guanli Banfa* (Measures for Regulating Takeovers of Listed Companies, hereinafter: 2006 Takeover Measures),[3] the 2005 *Zhonghua Renmin Gongheguo Gongsi Fa* (Company Law of the People's Republic of China, hereinafter: 2005 Company Law),[4] and the 2005 *Shangshi Gongsi Zhangcheng Zhiyin* (Company Guidelines for Articles of Association of Listed Companies, hereinafter: 2016 Guidelines for Articles of Association).[5]

a) 2005 Securities Law (as amended in 2014) and 2006 Takeover Measures (as amended in 2014)

The 2005 Securities Law devotes a whole chapter to the issue of takeovers. This chapter has a total of 16 provisions, but no provision specifically addresses whether, and if so, to what extent takeover defenses can be used. Art. 101 para. 2 authorizes the CSRC to promulgate detailed rules on takeovers. With this authorization, the CSRC has promulgated the 2006 Takeover Measures, which supersede the twin takeover regulations the CSRC issued in 2002.

The 2006 Takeover Measures are currently the centrepiece of China's takeover legal framework, containing two key provisions in relation to the issue of takeover defenses.[6] First, Art. 8 is a general rule governing the use of takeover defenses by reference to the directors' duties, stating that

"The directors, supervisors and senior managers of a target company shall assume the obligation of fidelity and diligence, and shall equally treat all the purchasers that intend to take over the said company.

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[2] 中华人民共和国证券法, *Zhonghua Renmin Gongheguo Zhenquan Fa,* first promulgated by the Standing Committee of the National People's Congress on 29 December 1998. The law underwent major changes in 2005, and relatively minor changes in 2004, 2013 and 2014. Hence it is customarily abbreviated as the 2005 Securities Law.

[3] 上市公司收购管理办法, *Shangshi Gongsi Shougou Guanli Banfa,* promulgated by CSRC on 31 July 2006. The law was amended in 2008, 2012 and 2014.

[4] 中华人民共和国公司法, *Zhonghua Renmin Gongheguo Gongsi Fa,* first promulgated by the NPCSC on 29 December 1993. The law underwent major changes in 2005, and relatively minor changes in 1999, 2004, 2013 and 2018. Hence it is customarily abbreviated as the 2005 Company Law.

[5] 上市公司章程指引, *Shangshi Gongsi Zhangcheng Zhiyin,* Guidelines for the Articles of Association of Listed Companies), promulgated by CSRC in December 1997, amended in March 2006, May 2014, October 2014, September 2016. The amendments in 2016 were just made to reflect the Shenzhen-Hong Kong Stock Connect Program and do not affect the takeover defense related clauses.

[6] H. HUANG, The New Takeover Regulation in China: Evolution and Enhancement, The International Lawyer 42 (2008) 153.

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

Second, Art. 33 specifically prohibits the use of certain takeover defenses without the approval of the shareholder meeting, providing that

"During the period after the announcement of a takeover bid and before the completion of the takeover bid, except for conducting ordinary business operations and implementing resolutions made by the general meeting of shareholders, target company management should not cause major impacts on the assets, liabilities, entitlements or business performances of the target company by disposing of assets, engaging in external investments, adjusting the main businesses, providing guarantees or loans and others."

The basic tenet of this provision is that takeover defenses must not be taken unless they are approved by shareholders at the general meeting. There are, however, some constraints on its application. Looking into the words of this provision, it seems that its application is subject to two conditions, including (1) takeover defenses must cause major impacts on the assets, liabilities, entitlements or business performances of the target company; and (2) takeover defenses must be taken after the announcement of takeover bids.[7] There is a further exemption: the takeover defense is carried out in the ordinary business of the company. As a consequence, under Art. 33, a takeover defense may be lawfully adopted even without the approval of shareholders, as long as it does not have a significant impact on company assets and liabilities, or it is taken before the announcement of a takeover bid, or it constitutes an ordinary business operation.

b) 2005 Company Law (as amended in 2018)

Change of control is by its nature a major event for the company concerned, and thus it is relevant to look at which corporate organ, the shareholder meeting or the board of directors, has power to make decisions on corporate control transactions, including the use of defensive tactics, under the company law of any given jurisdiction.

In China, the corporate governance system is basically shareholder-centred in that the shareholder meeting is the final decision-maker in relation to major issues of the company, including but not limited to electing and changing the directors and supervisors; making resolutions on increasing or decreasing the company's registered capital; making resolutions on the merger, division, change of company form, disbanding, or liquidation of the company; and

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[7] X. TANG, 反收购措施的合法性检验 *(Fan Shougou Cuoshi de Hefaxing Jianyan)* [An Examination on the Legitimacy of Anti-takeover Measures], 清华法学 *(Qinghua Faxue)* 2 (2008) 95.

revising the articles of association of the company.[8] In contrast, the board of directors is generally accountable to the shareholder meeting, with powers to work out major business plans and submit them to the shareholder meeting for approval.[9]

Allocating primary decision-making powers to the shareholders' general meeting rather than the board of directors has important implications for the use of takeover defenses in China. Many defensive measures may constitute major issues of the company and thus require the approval of shareholders. This would effectively limit the room for management to adopt defensive measures.

Apart from the general division of powers between the shareholder meeting and the board of directors, there are specific company law provisions that may affect the use of certain defensive tactics. For instance, the practice of the poison pill, a widely used takeover defense in the US, runs afoul of Art. 126 of the 2005 Company Law, which states that

> "[t]he issuance of shares shall comply with the principles of fairness and impartiality. The shares of the same class shall have the same rights and benefits. The same kind of shares issued at the same time shall be equal in price and shall be subject to the same conditions. The price of each share of the same kind purchased by any organization or individual shall be the same."[10]

In fact, even if discriminatory issuance is permissible, the issuance of new shares still faces significant legal barriers in China. Under the merits-review requirement of China's securities offerings regulation, for the company to issue new shares, it needs to meet certain substantive financial criteria and obtain approval from the CSRC.[11]

Neither can a Chinese listed company issue shares with superior voting rights under the current regulatory rules. As explicitly required by Company Law 2005, in the general meeting of shareholders, each share carries one voting right with it.[12] Under this mandatory rule, even if a company issues a class of shares with superior voting rights, the shares will be changed into ordinary shares in the general meeting.

Finally, before the recent 2018 revision to the 2005 Company Law, the practice of share repurchase could hardly be used as a takeover defense because it was allowed in very limited circumstances and required shareholder approval. Under the 2018 revision, it is easier for the company to conduct share repurchases. For instance, when it is necessary for a listed company to

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[8] Arts. 36, 98 of the 2005 Company Law.

[9] Arts. 46, 108 of the 2005 Company Law.

[10] Art. 127 of the 2005 Company Law.

[11] H. HUANG, The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in Light of the Global Financial Crisis, Hong Kong Law Journal 41 (2011) 261.

[12] Art. 103 2005 Company Law.

protect the corporate value and the rights and interests of shareholders, share repurchase may be allowed subject to a special resolution of the board of directors according to the company constitution or the authorization of the shareholder meeting.[13]

c) 2016 Guidelines for Articles of Association

In China, the CSRC, as the regulator of the securities market, has issued various rules for the corporate governance of listed companies. Of particular relevance to takeover defenses are the 2016 Guidelines for Articles of Association, which essentially provide a template for Chinese listed companies to make their articles of association. By way of this, the CSRC aims to ensure that the articles of association of listed companies are standard and formal, thereby enhancing the level of legal compliance and the quality of information disclosure.

It is made clear, however, that some variations to the template are allowed. Items in the 2016 Guidelines for Articles of Associations are meant to be the basic elements of the articles of association of listed companies. Without violating the relevant laws and regulations, the listed company can, depending on its particular circumstances, add items that are not contained in the 2016 Guidelines for Articles of Association, or adjust the wording or sequence of the items stipulated in the 2016 Guidelines for Articles of Association. In the event that the listed company adds to or adjusts the compulsory elements of the 2016 Guidelines for Articles of Association to meet its practical needs, these variations should be highlighted when the board of directors makes public announcements to revise the articles of association.

Hence, it is possible for listed companies to introduce takeover defenses by way of constitutional provisions if the following two conditions are met: the first condition is a substantive rule under which the constitutional provision does not violate the relevant laws and regulations, while the second is a procedural rule requiring the proper disclosure of the constitutional provision concerned.

III. A Comparative Perspective

From a comparative perspective, China's legal framework for takeover defenses, with the 2006 Takeover Measures as its core, is an instance of a legal transplant from overseas jurisdictions. The following Section will thus compare the Chinese law with its counterparts in overseas jurisdictions, which can shed light on the merits and demerits of the Chinese law.

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[13] Art. 142 2005 Company Law.

1. United States (Delaware Law)

In the US takeover defense regime, as represented by Delaware law, the directors of target corporations are vested with the primary powers in making important corporate decisions, including the decision to adopt takeover defenses.[14] In contrast, the roles assumed by shareholders are generally passive and reactive.[15] For instance, the board is empowered to initiate actions on fundamental corporate issues such as selling assets, mergers or charter amendments. Board approval is usually a prerequisite for a company to carry out these activities. Although shareholder approvals may also be needed, shareholders in general have no authority to alter or modify board proposals. Moreover, the residual powers, except those that are expressly granted to the general meeting of shareholders by statute or certificate of incorporation, are left to the board by statute.[16]

In order to prevent the target company's management from abusing their power to take defensive measures (for the sole purpose of entrenchment), US takeover law imposes levels of judicial review depending on the perceived possibility of management opportunism.[17] When target management adopts a defensive measure against a hostile bid, Delaware law applies the "modified business judgment rule", under which the directors are required "to show that after a 'good faith and reasonable investigation', they saw a danger to corporate policy and effectiveness."[18]

In general, the business judgment rule is essentially "a presumption that in making a business decision, directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company."[19] One implication of such a presumption is that plaintiffs who challenge management conduct carry the burden of rebutting the presumption.[20] The rule therefore importantly shields management decisions from judicial scrutiny.

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[14] *FLI Deep Marine LLC v. McKim,* No. 4138-VCN. 2009 Del. Ch. LEXIS 56 (Del. Ch. 21 April 2009) at 6.

[15] For a brief summary of management powers and shareholder powers provided by state law, see M. P. DOOLEY, Fundamentals of Corporation Law (Westbury, NY 1995) 174–177, 181.

[16] Delaware Code Title 8 Del. C. Corporations § 141 lit. a.

[17] C. KIRCHNER/R. W. PAINTER, Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform, The American Journal of Comparative Law 50 (2002) 451.

[18] KIRCHNER/PAINTER, *supra* note 17 (quoting *Cheff v. Mathes,* 199 A.2d 548, 555 (Del. 1964)).

[19] *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984) at 15, cited *Kaplan v. Centex Corp.,* Del. Ch., 284 A.2d 119, 124 (1971); *Robinson v. Pittsburgh Oil Refinery Corp.,* Del. Ch., 14 Del. Ch. 193, 126 A. 46 (1924).

[20] *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984) at 15, cited *Puma v. Marriott,* Del. Ch., 283 A.2d 693, 695 (1971).

The application of the business judgment rule in the context of takeover defenses is somewhat different from the normal application of the rule in terms of the burden of proof. As noted above, in ordinary business-judgment-rule cases the defendant management usually has the benefit of the presumption and then it is up to the plaintiff to rebut it, but in takeover defenses, the defendant management has some onus of proof before they can resort to the protection of the business judgment rule. This "modified business judgment rule" for takeover defenses is justified on the basis of the particular dangers of management using takeover defenses for entrenchment purposes.[21] The application of this rule to takeover defenses can be viewed from two landmark cases discussed below.

In 1985, the Delaware Supreme Court decided a leading case regarding takeover defenses: *Unocal Corp. v. Mesa Petroleum Co.*[22] In this case, Mesa Petroleum, a corporate raider with a national reputation as a 'green mailer',[23] made a front-end-loaded, two-tiered takeover bid for 37% of the shares of Unocal.[24] The front-end offer was 54 US-Dollars in cash, and the back-end offer was 54 US-Dollars in junk bonds. Mesa already held approximately 13% of Unocal's stock at the time of announcing the takeover bid. The board of Unocal viewed Mesa's offer as grossly inadequate, coercive, and having the threat of 'greenmail'. To protect the company against these threats, the board of directors initiated a selective exchange offer, offering to buy shares held by non-bidder shareholders at the price of 72 US-Dollars per share. The self-tender offer would be triggered upon Mesa acquiring 64 million shares of Unocal. In such circumstances, the company would buy back 49% of the outstanding shares from all the remaining shareholders except for Mesa. By excluding Mesa, the self-tender offer would provide differential treatment between Mesa and other company shareholders. The Supreme Court of Delaware confirmed the validity of the selective self-tender offer initiated by management. The court held that the adoption of such defensive measures

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[21] *Bennett v. Propp,* 187 A.2d 405, 409 (Del. 1962) at 22 (stating that "[w]e must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult.").

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

[23] The *Unocal* case (*supra* note 22) at 956. The term "greenmail" refers to the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover.

[24] In a "front-end loaded, two-tiered takeover bid", the offer is divided into two tiers; the consideration offered in the first tier is superior to the consideration offered in the second tier. The two-tier bid is to induce shareholders to tender their shares in the first-tier offer. M. BRADLEY et al., Synergistic Gains from Corporate Acquisitions and Their Division between the Stockholders of Target and Acquiring Firms, Journal of Financial Economics 21 (1998) 3, 16.

was in line with the duty and power of management to protect the corporation and its owners from perceived harms, including threats originating from an existing shareholder.[25]

In this case, the court made several important developments concerning the target management's duties in adopting anti-takeover defenses. The court held that the board of the target corporation "has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders".[26] Having established this general principle, the court then proceeded to articulate two reasonableness-based tests that management should satisfy before they can resort to the protection of the business judgment rule. The defendants, namely the target company directors, are required to show (1) "that they had *reasonable* grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership," and (2) that "it [i.e. the defensive measure] must be *reasonable* in relation to threat posed."[27] The court went on further to discuss the relational requirement, stating:

> "This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of the securities being offered in the exchange. […] While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor."[28]

As noted earlier, under this "modified business judgment rule", the defendant, not the plaintiff, bears the burden of proof.[29] This makes judicial review act as a deterrent to abusive use of takeover defenses.

Revlon Inc. v. MacAndrews & Forbes Holdings, Inc. further developed the duties of target management when using defensive measures.[30] There, the acquirer, Pantry Pride, approached the management of the target company Revlon, offering to buy the company's shares at 40–42 US-Dollars per share. Management decided the offer was grossly inadequate and adopted several defensive measures such as the repurchase of company shares, with the hope

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[25] *Supra* note 22, at 950.

[26] *Supra* note 22, at 954.

[27] *Supra* note 22, at 955 (emphasis added).

[28] *Supra* note 22, at 955–956 (footnotes omitted).

[29] *Supra* note 22, at 954–955. The court stated that there exists an "omnipresent spectre" of conflict of interest in the use of takeover defenses, even though this conflict falls short of the express conflict in the traditional cases, such as a self-dealing transaction; based on this conflict, the court switched the burden of proof to the defendants.

[30] *Revlon, Inc. v. MacAndrews and Forbes Holdings,* 506 A.2d 173 (Del. 1986).

of fending off the takeover attempt. Pantry Pride was, however, rather determined to obtain control. It first made a takeover bid at 47.50 US-Dollars per share; it then continued to raise its offer, all the way to 56.25 US-Dollars per share. While recognising the sale of control as inevitable,[31] the Revlon board decided to seek another buyer, Forstmann. The management agreed to grant Forstmann several favourable terms such as a cancellation fee of 25 million US-Dollars. Forstmann made a competing bid, offering to pay 57.25 US-Dollars per share to participating shareholders. The initial bidder, Pantry Pride, responded by raising its offer to 58 US-Dollars per share, and also applied to the court to enjoin the favourable terms offered by management to Forstmann.[32]

The court considered that the initial defensive measures taken by management justifiably preserved corporate interests in the long term.[33] Nonetheless, the situation started to change when the sale of the company became inevitable. Under such circumstances, the directors must discharge their duties by obtaining the highest price for shareholders, rather than maintaining the corporate enterprise, and cannot adopt a defense for the purpose of giving absolute priority to a non-shareholder constituency.[34] Finally, the Revlon directors were found to have breached their duty of care by entering into contracts with the friendly acquirer and effectively ending an active auction for the company.[35]

Thus, the defenses permitted by *Unocal* could be a breach of the directors' fiduciary duty if the company is in the same situation as *Revlon.* Two subsequent cases, *Paramount Communications, Inc. v. Time, Inc.*[36] and *Paramount Communications, Inc. v. QVC Network Inc.,*[37] offered some guidance to distinguish defensive transactions that put a company into a *Revlon* situation from transactions that do not. For instance, the *Revlon* duties may be triggered "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganisation involving a clear break-up of the company", or "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company".[38]

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[31] The *Revlon* case, *supra* note 30, at 182.

[32] *Supra* note 30.

[33] The initial defensive measures adopted by management to fend off the takeover attempt of Pantry Pride, which included the poison pill and the share repurchase, were held as proportionate and reasonable. *Supra* note 30, at 20–22.

[34] *Supra* note 30. Other states, however, allow the target directors to consider the interests of non-shareholder constituencies in the context of takeovers. Furthermore, "Connecticut […] requires directors to consider non-shareholder constituencies in change of control transactions." See KIRCHNER/PAINTER, *supra* note 17, 453, para. 7.

[35] *Supra* note 30, at 176.

[36] *Paramount Communications, Inc. v. Time, Inc.,* 571 A.2d 1140 (Del. 1989).

[37] *Paramount Communications v. QVC Network,* 637 A.2d 34 (Del. 1994).

[38] *Supra* note 36, at 33, 34.

It is important to acknowledge that the US business judgment rule, even with the shifted burden of proof, still leaves considerable room for management to adopt defensive measures at their discretion. For instance, the Unocal case involved some rather controversial defensive measures, including the selective exchange offer which gave different treatment between acquirer-shareholders and remaining shareholders. Moreover, the selective tender offer placed management in a position with severe conflicts of interest. While the offer excluded acquirer-shareholders from participating, management themselves sold a substantial number of their own shares back to the company at a premium. Thus, it can be argued that the selective tender offer benefited the personal interests of management at the cost of certain shareholders. Indeed, the selective tender offer was held by the trial judge to be legally impermissible,[39] but was overruled by the Delaware Supreme Court through the application of the business judgment rule. In 2002, however, the SEC issued Rule 14d-10 to prohibit the selective offer.[40]

2. *United Kingdom*

In the UK, the conduct of target management in the context of takeovers is regulated by both the law governing management fiduciary duties and the board neutrality rule under the City Code on Takeovers and Mergers (City Code).[41] Compared to the US law, the UK law leaves much less discretion to management in adopting defensive measures.[42]

The board neutrality rule generally prevents the board from taking defensive measures to defeat an imminent takeover offer without obtaining approval from shareholders. The General Principle of the City Code requires that "the board of an offeree company must not deny the holders of securities the opportunity to decide on the merits of the bid".[43]

The general principle is further developed through the following two specific rules: Rule 21.1 of the City Code provides that

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[39] The *Unocal* case, *supra* note 22, at 949.

[40] 17 C.F.R. § 240.14d-10 (2002); see K. MARK, Structuring Transaction Outside All Holders/Best Price Rule, Fordham Journal of Corporate & Financial Law 9 (2003) 518–519.

[41] The Panel on Takeovers and Mergers, The Takeover Code (2006), available at <http://www.thetakeoverpanel.org.uk/new/codesars/data/code.pdf>.

[42] The amendments made to the UK Takeover Code are also relevant, which overall further restrict discretionary use of takeover defenses by management. See A. O. C. SAULSBURY, The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies, Delaware Journal of Corporate Law 37 (2012). The UK takeover law served as a model for the 13th EU Directive on Takeovers of 2004, and has been followed by many countries in continental Europe.

[43] The City Code on Takeovers and Mergers (UK), General Principles 3.

"During the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent, the board must not, without the approval of the shareholders in general meeting:

(a) take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits; or

(b) (i) issue any shares or transfer or sell, or agree to transfer or sell, any shares out of treasury; (ii) issue or grant options in respect of any unissued shares; (iii) create or issue, or permit the creation or issuance of, any securities carrying rights of conversion into or subscription for shares; (iv) sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount; or (v) enter into contracts otherwise than in the ordinary course of business."[44]

Rule 20.2 requires that any information given to one offeror or potential offeror, must, on request, be given equally and promptly to another offeror or *bona fide* potential offeror. This requirement applies even if that other offeror is less welcome.[45]

The general principle, together with Rule 20.2, and Rule 21.1 cited above, constrains the discretions enjoyed by management in defeating an imminent takeover threat or an announced takeover bid. The board is especially required to remain neutral in terms of adopting certain post-bid defenses including issuing new shares, disposing of major assets, and supplying information to competing bidders.

The board neutrality rule above mainly applies to post-bid defenses, namely defensive measures adopted after the emergence of an imminent takeover offer. Pre-bid defenses, namely defensive measures adopted before the emergence of a takeover threat, are mainly governed by general company law.[46] The fiduciary duty of management, especially the duty of management to exercise their powers for a proper purpose, is an important rule that regulates pre-bid defenses. As the court put it,

"Where the question is one of abuse of powers, the state of mind of those who acted, and the motive on which they acted, are all important, and you may go into the question of what their intention was, collecting from the surrounding circumstances all the materials which genuinely throw light upon that question of the state of mind of the directors so as to show whether they were honestly acting in discharge of their powers in the interests of the company or were acting from some bye-motive, possibly of personal advantage, or for any other reason."[47]

More specifically, the landmark case *Howard Smith Ltd v Ampol Petroleum Ltd* (the *Howard Smith* case) illustrates how the court applies the duty to act for the

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[44] The City Code on Takeovers and Mergers (UK), Rule 21.1.

[45] The City Code on Takeovers and Mergers (UK), Rule 20.2.

[46] P. DAVIS/S. WORTHINGTON, Gower and Davies' Principles of Modern Company Law (9th ed., London 2012) 988.

[47] *Hindle v. John Cotton Ltd,* [1919] 56 Sc.L.R. 625, at 630–631; See also the *Re Smith & Fawcett Ltd,* [1942] Ch 304, at 306.

proper purposes to defensive measures adopted by management.[48] In this case, the hostile acquirer Ampol Petroleum, together with its associate, held more than 50% of the shares in the target company, Miller. Ampol made a hostile offer to buy all the remaining shares of Miller at 2.27 Pounds Sterling per share. Management unanimously considered the offer to be inadequate and recommended that shareholders reject the offer. Shortly after the announcement of the original hostile takeover offer, another acquirer, Howard Smith, offered to buy the company shares at 2.50 Pounds per share (cash) or 2.76 Pounds per share (cash and securities). The competing bid, although bringing higher returns to shareholders, had little chance to succeed. Ampol and its associates, who together held more than 50% of the shares, refused to attend the bid made by Howard Smith. The management of Miller decided to issue 4.5 million shares to Howard Smith, which would dilute the shareholding of Ampol to 36.6%. Consequently, Howard Smith would be able to make an effective takeover bid to obtain control under the new shareholding structure.

An important dispute in this case is whether management was acting for proper purposes when making the share allotment.[49] Raising capital is a common purpose of share allotment. However, the courts held that based on the company's financial status, raising capital was not the primary purpose of the allotment of shares witnessed in this case. Rather, the management's primary purpose was to dilute the existing majority bloc.[50] The courts further held that

> "it must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority or creating a new majority which did not previously exist. To do so is to interfere with that element of the companys' constitution which is separate from and set against their powers".[51]

Based on the finding of improper purpose, the courts ordered that the share allotment be set aside and that the register be rectified.

The case provides a good illustration of the differences between applying the US business judgment rule and the UK fiduciary duty standards to takeover defense cases. To make a bold postulation, the defensive measures set aside by the UK courts under the proper purpose test in this case would probably be validated by the US business judgment rule. One way to interpret the postulation is to compare the Howard case to the Revlon case. As a bidding contest between Ampol and Howard Smith was in progress, the target com-

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[48] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 NSWLR 68 (Privy Council).

[49] The directors in this case acted under clause 8 of the company's Articles of Association. This provides that directors may allot or otherwise dispose of shares. Nonetheless, the directors' power under this Article is a fiduciary power. The exercise of such a power may be attacked on the ground that it was not exercised for the purpose for which it was granted. See the *Howard Smith* case, *supra* note 48, at 76.

[50] The *Howard Smith* case, *supra* note 48, at 79–80.

[51] *Supra* note 48, at 79.

pany Miller can be considered to have been in a stage where the break-up of a company is inevitable.[52] According to the Revlon decision, management are required to maximize shareholder returns when the break-up of a company is inevitable. In the *Howard Smith* case, the share allotment used by management aimed to induce the competing bid made by Howard Smith, which offered a higher price to shareholders. That is to say, management, in adopting the defensive measure, properly performed the duty to maximize shareholder returns. The defensive measure therefore would be validated if the US Revlon decision applied to the case.

In short, besides the Takeover Code, the directors of the target company in the UK are also subject to equitable principles of fiduciary law. This fiduciary-duty-based system is conceptually similar to that of the US, but there are some nuanced differences in the content or judicial interpretations of the amorphous notion of fiduciary duty.[53] In the UK, particularly under the board neutrality rule, the shareholders, rather than the directors, have the final say with respect to the employment of defensive measures. Some defensive measures that can be decided by management alone in the US either require shareholder approval or are simply disallowed in the UK.[54]

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[52] It is debatable whether the break-up of a company is inevitable in the face of an active bidding contest. However, even if the company was not up for sale, management conduct in the *Howard* case could still be justified under the *Unocal* decision as they were taking reasonable measures to defend long-term company interests.

[53] For a more detailed comparison of the directors' duties in the context of takeovers in several commonwealth countries, see, e.g., J. H. FARRAR, Business Judgment Rule and Defensive Tactics in Hostile Takeover Bids, Canadian Business Law Review 15 (1989); J. MAYANJA, Reforming Australia's Takeover Defence Laws: What Role for Target Directors? A Reply and Extension, Australian Journal of Corporate Law 10 (1999) 162, 164.

[54] A good example is the shareholder rights plan, which in simple terms gives no acquirer shareholders an option to obtain company shares at significant discounts. Shareholder rights plans are strictly prohibited in the UK. J. ARMOUR/D. A. SKEEL Jr., Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation, Georgetown Law Journal 95 (2007) 1727, 1735–1736 (Stating that "unlike their U.S. brethren, UK managers are not permitted to take any 'frustrating action' without shareholder consent once a takeover bid has materialized. Poison pills are strictly forbidden, as are any other defenses, such as buying or selling stock to interfere with a bid or agreeing to a lock-up provision with a favored bidder, that would have the effect of impeding target shareholders' ability to decide on the merits of a takeover offer. To be sure, the 'no frustrating action' principle of the UK's Takeover Code only becomes relevant when a bid is on the horizon. […] Yet, other aspects of UK law and practice – including rules that prevent effective staggered boards – mean that embedded defenses are not observed on anything like the scale that they are in the United States".).

3. *China: A Mix of the US and UK Experiences*

The preceding discussion reveals that the US and UK adopt two approaches to regulating takeover defenses. In the US, management has wide authority to adopt defensive measures under the modified business judgment rule. Many of the defensive measures used in the US can be decided by management alone; in some circumstances, they require approval from both management and shareholders. The UK law, in contrast, is comprised of the fiduciary duty of management, which requires management to act for the bona fide best interests of the company and to act for a proper purpose, as well as the board neutrality rule under which the board of directors should remain neutral upon the emergence of an imminent takeover offer and must not deny shareholders the opportunity to assess the offer. In the UK, therefore, the scope for the management to adopt defensive measures is much narrower, and the shareholders play a greater role in this area.

The Chinese regulation of takeover defenses is mainly comprised of three categories of rules: the fiduciary duty of management, the Chinese board neutrality rule, and the primacy of shareholders in the allocation of powers between management and shareholders. Based on the above discussion of overseas experiences, it may seem that the Chinese law borrows from the UK experience. Upon closer examination, however, the Chinese law, despite some resemblance to the UK law on the books, is more similar to the US law in its regulatory effects.

Specifically, the Chinese board neutrality rule under Art. 33 of the 2006 Takeover Measures requires shareholder approval for takeover defenses, which is similar to the approach taken by the City Code in the UK. Nonetheless, the Chinese board neutrality rule has very limited applicability. It only applies to defensive measures that fulfil the following preconditions: (1) they must significantly change company assets and liabilities; (2) they must be taken after the announcement of takeover bids. This leaves considerable room for management to adopt post-bid defenses by getting around the two conditions. The use of defenses is then effectively subject only to the fiduciary duty requirement.

The 2005 Company Law divides the fiduciary duty into two categories, namely the duty of loyalty and the duty of care, stating that "[…] the directors, supervisors and senior executives of a company shall comply with the laws, administrative regulations, and the articles of association of the company, and bear the duties of loyalty and due diligence towards the company.'[55]

[55] Art. 148 of the 2005 Company Law. In Japan, the regulation of takeover defenses has been developed under the heavy influence of the US experience, particularly Delaware law such as the Unocal rule. C. J. MILHAUPT, In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan, Columbia Law Review 105 (2005) 2171.

The 2005 Company Law defines the fiduciary duty of loyalty through a number of prohibiting provisions. Most relevant to takeovers, the law prohibits management from depositing corporate funds into an account of their own or anyone else's, loaning corporate funds to others, providing any guarantee to any other person by using the company's property, or seeking business opportunities for themselves or any other person by taking advantage of management powers.[56]

The 2005 Company Law itself does not define the fiduciary duty of care. Nonetheless, the 2016 Guidelines for Articles of Association provide some clues as to what constitutes the duty. According to Article 98, management should exercise their powers prudently, conscientiously, and diligently; management should treat all the shareholders in a fair manner; and management should ensure that information disclosed by the company is real, accurate and complete.[57]

The Takeover Measures 2006 reiterate the duties of care and loyalty provided in general corporate law, which are both owed by management to their company. They further provide specific rules regarding the fiduciary duty of management in takeovers:

> "The directors, supervisors and senior managers of a target company owe *the duty of loyalty and the duty of care* to the company; they should treat all the purchasers who intend to obtain control of the said company in a fair manner.
>
> The decisions made by the board of directors and the measures taken by the board towards takeovers should serve the goal of protecting interests of a company and its shareholders; [the board of directors] should not abuse their powers to cause improper obstacle to takeovers, it should not use company assets to provide any financial aid to the purchaser; it should not cause damages to the lawful rights of the said company or its shareholders."[58]

The Chinese fiduciary duty provisions quoted above use many general terms such as "protecting the lawful interests of a company and its shareholders", and "to treat all the acquirers in a fair manner and not to cause improper obstacle to takeovers". These general terms are necessary as they enable the law to address contingencies in practice. Nonetheless, these terms leave many questions unanswered regarding the legitimacy of takeover defenses used by management. Indeed, the legal texts on directors' duties in China are couched in simple and general terms, and the courts have not provided much further guidance on the meaning of directors' duties.[59] Then how has Art. 8 of the 2006 Takeover Measures been enforced in regulating takeover defenses? The

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[56] Art. 149 of the 2005 Company Law.

[57] Art. 98 of the 2016 Guidelines for Articles of Association.

[58] Art. 8 Takeover Measures 2006, emphasis added.

[59] G. XU et al., Directors' Duties in China, European Business Organization Law Review 14 (2013) 57.

next section will try to answer this question by empirically examining the use of takeover defenses in practice.

The board neutrality rule provided in the 2006 Takeover Measures reads as follows:

> "During the period after the announcement of a takeover bid and before the completion of the takeover bid, except for conducting ordinary business operations and implementing resolutions made by the general meeting of shareholders, target company management should not cause major impacts on the assets, liabilities, entitlements or business performances of the target company by disposing of assets, engaging in external investments, adjusting the main businesses, providing guarantees or loans and others."[60]

The Chinese board neutrality rule quoted above is similar to the UK one, both requiring shareholder approval for post-bid defenses[61]. Nonetheless, the Chinese board neutrality rule has very limited applicability compared to its UK counterpart. As can be seen above, the Chinese rule only applies to defensive measures that fulfil the following preconditions: (1) they must significantly change company assets and liabilities; (2) they must be taken after the announcement of takeover bids.

The Chinese board neutrality rule, due to its limited applicability, leaves considerable room for management to adopt post-bid defenses. In principle, the board is permitted to adopt defensive measures that do not meet the above two preconditions, which include defensive measures having no significant influences on the assets and liabilities of a company and defensive measures adopted before the official announcement of takeover bids.

As to the allocation of corporate powers, Chinese corporate law in general leaves the general meeting of shareholders with primary powers in making major corporate decisions. The general meeting of shareholders is described by the Chinese law as "the authority of a company",[62] while the board of directors is described as "responsible to the general meeting of shareholders".[63] Chinese corporate law grants a wide range of powers exclusively to the general meeting of shareholders. Important examples include selecting management and determining their remuneration, approving resolutions on the issuance of securities, conglomeration and split-up of a company, and revising the articles of association of the company.[64]

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[60] Art. 33 Takeover Measures 2006.

[61] For relevant UK rules, see *supra* note 44.

[62] Art. 37 of the 2005 Company Law.

[63] Art. 47 of the 2005 Company Law.

[64] Arts. 38, 100 of the 2005 Company Law.

IV. The Use of Takeover Defenses

Depending on the time when takeover defenses are used, they can be broadly divided into two categories, namely *ex-ante* defenses and *ex-post* defenses. *Ex-ante* defenses are introduced before the emergence of an imminent takeover offer, and they usually take the form of provisions in the articles of association of listed companies. It is worth noting that in a broad sense, *ex-ante* defenses may take other forms, such as the increase of shareholdings by way of direct acquisition of shares or cross-shareholding arrangements. These types of *ex-ante* defenses are essentially adopted by existing shareholders, and not the incumbent management of the target company. They are not the focus of the discussion here, as the legal concern over takeover defenses primarily arises from the possibility of the target management abusing them for the purpose of entrenchment. In theory, constitutional provisions need to be approved by shareholders, but in practice, due to the agency costs inherent in the shareholder-management relationship, the management can exert significant influence on constitutional provisions to pursue their own interests.

By contrast, *ex-post* defenses are initiated after a specific takeover threat arises, and apart from constitutional provisions, there are a variety of defensive tactics. In general, *ex-ante* defenses are proactive, prophylactic and longstanding, while *ex-post* defenses are reactive, targeted and one-off.

1. Ex-Ante Defenses

Anti-takeover constitutional provisions are quite common amongst Chinese listed companies, particularly those with a dispersed shareholding structure. They can be broadly grouped into three categories: (1) obstacles to the acquirer purchasing shares; (2) obstacles to the acquirer electing new board members; (3) others. Empirical study shows that all the three categories of provisions have been adopted by Chinese listed companies.

a) Obstacles to the Acquirer Purchasing Shares

In the first category, the anti-takeover constitutional provision usually requires that if a shareholder comes to hold more than five or ten per cent of shares, they should notify the company and obtain approval from the board as well as the general meeting before they can acquire more shares. Historically, failure to obtain such approval would, according to company constitutions, cause the acquirer to lose certain shareholder rights. One company constitution once made it clear that if the board is not notified and its approval is not obtained, the shares acquired by the shareholder do not carry the right to elect board members in the general meeting.[65]

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[65] Art. 38 Constitution of 梅花集团 (*Meihua Jituan,* 600873), revised in 2013.

Such direct and absolute restriction of share acquisition is problematic as it may entrench the incumbent management. In the past two years, obstacles to further share acquisition have taken the subtler form of a "disclosure clause". As provided in one company constitution, after reaching 1% or 3% thresholds, an acquirer should disclose details of an acquisition to the board.[66] Some companies further provide that additional acquisition of shares during this disclosure period is prohibited.[67]

b) Obstacles to the Acquirer Electing/Dismissing Board Members

The second category contains most of the anti-takeover constitutional provisions used by Chinese listed companies and can be further divided into seven types.

(1) Restricting the right to nominate board members

Under Chinese company law, shareholders who individually or collectively hold more than 3% of shares have the right to put forward proposals to the general meeting regarding the nomination of new board members.[68] Many companies seek to restrict such rights by raising the criteria above statutory thresholds for shareholders to exercise their rights. These companies usually require shareholders to have a 5% or higher level of shareholding in order to nominate board members or to have held shares for a minimum period of time (for example, 180 days). 67 of the companies studied either have a higher shareholding threshold or require a longer holding period, or have both requirements. Seven companies add restrictions on how shareholders nominate board members. For instance, one company constitution provides that every 15% shareholding can nominate one board member.[69]

(2) Restricting the right to convene a general meeting

As part of their efforts to gain effective control, hostile acquirers may need to convene a general meeting in order to revise constitutions or approve share issuance plans. Under Chinese company law, shareholders individually or collectively holding more than 10% of shares enjoy the right to convene a general meeting if the board of directors or supervisory board has failed to do so.[70] Such a right, however, has been restricted by company constitutions by requiring a 90- or 180-day holding period for shareholders to exercise their rights.[71] Two companies in the research have such a restriction.

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66 Art. 37 para. 5 Constitution of 世联行 (*Shilianhang* 002285), revised in 2016.
67 Art. 40 Constitution of 柳工 (*Liugong,* 000528), revised in 2016.
68 Art. 102 of the 2005 Company Law.
69 As an example, see Art. 58 Constitution of 柳工 (*Liugong,* 000528), revised in 2016.
70 Art. 100 of the 2005 Company Law.

(3) Prohibition of the dismissal of board members without cause

Most Chinese companies in the research provide in their constitutions that directors should not be dismissed within their term of office without cause. The widespread use of such a provision can be explained by reference to the historical development of Chinese company law. The 1993 company law explicitly prohibited the dismissal of management without cause,[72] but this provision was deleted in the 2005 company law revision. This means that the company can now dismiss its directors without cause. In practice, however, most companies have chosen to retain the requirement through constitutional provisions.[73]

(4) Staggered board

Furthermore, there is a so-called "staggered board" provision, under which the term of office for the director is often set at three years, and only a proportion of the incumbent directors – usually one third – can be replaced at a general meeting of shareholders. The staggered board mechanism can cause delays and uncertainties for the acquirer's efforts to obtain control in the boardroom. Suppose a company constitution divides the board of directors into three classes and requires only one class of directors to be replaced at each general meeting. The acquirer will then have to wait for at least two general meetings in order to obtain the majority of seats in the boardroom. Eight companies in the research have staggered board provisions.

(5) Golden parachute

Under the "golden/silver parachutes" provision, the incumbent management, including directors and senior managers, can get compensation if they are dismissed before the expiry of their term of office in the event of a takeover. The compensation may take different forms, such as cash and shares, and the value is usually substantial.[74]

(6) Qualification requirements for board members

Constitutional provisions were found to impose demanding (sometimes unreasonable) qualification requirements for the chairperson and other board members. For instance, one such requirement is that for someone to be elect-

[71] Art. 48 Constitution of 深赛格 (*Shensaige,* 000058), revised in 2016, Art. 48 Constitution of 长城信息 (*Changcheng Xinxi,* 000748), revised in 2012.

[72] Art. 47 of the 1993 Company Law.

[73] The CSRC seems to support this, as the above constitutional provision is still included under Art. 96 of the 2016 Guidelines for Articles of Association that it issued for listed companies.

[74] Art. 13 Constitution of 雅化集团 (*Yahua Jituan,* 002497), revised in 2016.

ed as the chairperson of the board of directors, he must have worked within the company for a specified period of time such as five years.[75] Clearly, this makes it difficult for the acquirer to elect their people – who will likely be outsiders to the company – to the board of the target company.

(7) Employee directors on the board

One company in the research proposed revising its constitution to require employee directors on the board.[76] Such a requirement would create barriers for hostile acquirers to change the board members. This provision, however, failed to obtain approval at the general meeting.

c) Others

The last two sections described defensive measures that are frequently used and discussed in China. In recent years, new defensive strategies have arisen and some of them have been widely adopted.

(1) Restricting shareholders' right to put proposals to the general meeting

Under Chinese company law, shareholders individually or collectively holding more than 3% of shares enjoy the right to put proposals to the general meeting.[77] As a defensive measure, company constitutions will provide a higher shareholding threshold or a longer holding period as preconditions for shareholders to exercise their right of making proposals. Nine companies in the research restrict the right of shareholders to make proposals.

(2) Restricting shareholders' right to vote in the general meeting

Under Chinese company law, a special resolution of the general meeting needs to be adopted by shareholders representing 2/3 or more of the voting rights of the shareholders present.[78] A resolution of the board of directors should be adopted by more than half of all the directors.[79] Twenty companies in the research have raised the quantitative standards for passing resolutions at the general meeting. For instance, some company constitutions provide that proposals put forward by a hostile acquirer regarding corporate assets need to

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[75] Art. 97 Constitution of 世联行 (*Shilianhang,* 002285), revised in 2016.

[76] 廊坊发展 (*Langfang Fazhan,* 600149), 廊坊发展股份有限公司关于修改公司章程的公告 *(Langfang Fazhan Gufen Youxian Gongsi Guanyu Xiugai Gongsi Zhangcheng de Gonggao)* [Notice of Disclosure of Langfang Fazhan on Revising Company Constitution], 2016-044.

[77] Art. 102 of the 2005 Company Law.

[78] Art. 103 of the 2005 Company Law.

[79] Art. 11 of the 2005 Company Law.

be approved by shareholders representing 3/4 or more of the voting rights of the shareholders present.[80]

(3) Empowering the board to take defensive measures without authorization from the general meeting

The board of directors certainly can adopt defensive measures. However, Chinese company law is rather vague on the extent to which the board can take defensive measures. To clarify the boundaries, some company constitutions empower the incumbent board to take defensive measures not prohibited by legislation or the company constitution, and not in violation of company interests. The adoption of such defensive measures does not need to be authorized by the general meeting.[81]

One company constitution provides that when it is subject to a hostile takeover, any shareholder other than the acquirer who individually or collectively holds ten per cent or more of the total shares has the right to require the board, in writing, to take defensive measures which are not prohibited by the relevant laws and regulations. Without obtaining approval from the general meeting, the board can immediately employ defenses after the receipt of such a written document or resolution. The board should make an announcement to shareholders after the use of defenses.[82] Under such an authoritative clause, the board can use defenses simply at the request of large shareholders.

(4) Prohibiting directors from providing aid to hostile acquirers

One company constitution in the research provides that directors owe fiduciary duties to the company. They should not, in violation of corporate interests, provide any aid to hostile acquirers.[83]

(5) Requiring large shareholders to act in concert

One company constitution was found to require that the largest five shareholders must act in concert in the face of hostile takeovers. Shareholders who act otherwise should compensate the other shareholders 25% of their shareholding.[84]

For ease of reference, the various types of *ex-ante* defenses discussed above are summarized in table form below.

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[80] Art. 82 Constitution of 多氟多 (*Duofuduo,* 002407), revised in 2016.
[81] Art. 109 Constitution of 世联行 (*Shilianhang,* 002285), revised in 2016.
[82] Art. 159 Constitution of 柳工 (*Liugong,* 000528), revised in 2016.
[83] Art. 102 para. 10 Constitution of 多氟多 (*Duofuduo,* 002407), revised in 2016.
[84] Art. 31 Constitution of 兰州黄河 (*Lanzhou Huanghe,* 000929), revised in 2014.

Table 1: Types of ex-ante defenses provided in company constitutions

	Constitutional Provisions
	Obstacles to the acquirer purchasing shares
1	Share acquisitions above certain thresholds need to be approved
	Obstacles to the acquirer electing/dismissing board members
1	Restricting the right to nominate board members
2	Restricting the right to convene a general meeting
3	Prohibition of the dismissal of board members without cause
4	Staggered board
5	Golden/silver parachutes
6	Qualification requirements for board members
7	Employee directors in the board
	Others
1	Restricting shareholders' right to put proposals to the general meeting
2	Restricting shareholders' right to vote in the general meeting
3	Empowering board to take defensive measures without getting approval from shareholders
4	Prohibiting directors from providing aid to hostile acquirers
5	Requiring large shareholders to act in concert

2. *Ex-Post Defenses*

Below is a list of the *ex-post* defenses used in the Chinese securities market. The first is the so-called "white knight", a practice of inviting a friendly acquirer to make a competing bid. A good example is the takeover battle between Guangfa Zhengquan (the target company) and Zhongxin Zhengquan (the acquirer), which illustrates well how friendly acquirers can act together to defeat a takeover threat.[85] In September 2004, the hostile acquirer, Zhongxin Zhengquan, announced a takeover bid, offering to buy the remaining shares of the target company Guangfa Zhengquan at 1.25 Yuan per share. The target company responded to the hostile bid by setting up a company called Shenzhen Jifu, the shares of which were subscribed to by the management and employees of Guangfa Zhengquan. Shenzhen Jifu obtained around 12.23% of the target company shares from existing block holders. Shenzhen Jifu was, however, constrained by its financial capacities from making further share acquisitions.

Two other acquirers associated with the target company emerged at this point. The target company had cross-shareholding arrangements with two of its largest shareholders, Liaoning Chengda and Jilin Aodong, which held 24%

[85] H. SHEN/H. WANG, 反并购：理论 策略 实施 案例（反收购 理论 策略 实施 案例 *(ST meiya Shougou yu Fanshougou Dazhan)* [Takeover Defenses: Theories, Strategies, Implementation and Cases], Directors and Boards 9 (2007).

and 13.75% of shares in the target company respectively. The target company was the second-largest shareholder in Liaoning Chengda and the fifth-largest shareholder in Jilin Aodong. The cross-shareholding tied the target company and its two largest shareholders together through their common economic interests. To preserve such common economic interests, the two largest shareholders conducted a number of negotiated share acquisitions from other holders of share blocks, which were aided by the incumbent management. After the negotiated share acquisitions, the three friendly acquirers – Shenzhen Jifu, Liaoning Chengda and Jilin Aodong – jointly held 66.67% of the target company shares. The hostile bidder withdrew its offer, as it was impossible for it to obtain majority shares even if all the remaining shareholders had tendered their shares.

The second defense is to win support from minority shareholders and stakeholders for the purpose of fending off a hostile takeover threat. The failed hostile takeover attempt against ST Meiya is a typical case in point.[86] There, the target company was in severe financial distress for more than two years. The controlling shareholder of the company, which was the local state asset regulator, intended to transfer the 29% of the shares it held to the hostile acquirer, Wanhe Jituan. In September 2003, without consulting with and obtaining consent from the incumbent management, the controlling shareholder of ST Meiya entered into a share transfer agreement with the acquirer.

The disclosed contract met with strong opposition from the management of the target company. The incumbent management claimed, both in the media and in corporate meetings, that the intended transfer of shares would be detrimental to long-term corporate interests because the acquirer mainly operated in a different industry than the target company and thus would not be competent to run the target company. In order to win support from employees, the board of directors resolved to make a payment to their superannuation, which had been put off for a long time. Soon after the target management initiated these defensive measures, the existing controlling shareholder terminated the share transfer agreement with the hostile acquirer and entered into a new agreement with a friendly acquirer recommended by management.

Generally speaking, winning support from minority shareholders can defeat a hostile takeover attempt by leaving insufficient shareholding for hostile acquirers to obtain control. Additionally, as seen in this case, the support of relevant stakeholders such as employees may be an important consideration in SOE-related transactions. Strong opposition from minority shareholders and stakeholders may dissuade the state asset regulator from selling shares to a hostile acquirer, as it may give rise to concerns over social stability, which is currently a political priority of the Chinese government.

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[86] A. LV, ST美雅收购与反收购大战 *(STmeiya Shougou yu Fanshougou Dazhan)* [Hostile Takeover and Takeover Defenses surrounding ST Meiya], China Investment 2004.

The third defense is to file complaints with the CSRC or the court. As the Chinese securities regulator, the CSRC is charged with reviewing takeover transactions, intervening in the transaction process and mandating that the relevant participants take certain actions. If the complaints filed by certain parties lead to certain actions taken by the CSRC, it may defeat a hostile takeover attempt.

In China's first hostile takeover case in 1993, the takeover of Yanzhong Shiye (the target company) by Shenzhen Baoan (the acquirer), the target company management filed a complaint to the CSRC, accusing the acquirer of breaching relevant disclosure rules for takeovers. The complainant also claimed that the bid was funded by bank loans, which was prohibited under Chinese law at that time. The CSRC intervened by mediating the disputes between the two parties. The validity of the share acquisition was upheld, but the acquirer sought to retain management employment after obtaining control.[87]

Alternatively, a complaint may be made to the court. The civil litigation filed by Sanlian Shangshe against Guomei Dianqi provides a recent example of this defense.[88] In February 2008, by way of a judicial auction, Longji Dao obtained 10.9% of shares in the target company, Sanlian Shangshe, but it was later revealed that Longji Dao was only a "shadow" acquirer that was used by the real acquirer, Guomei Dianqi. Soon after the purchase of shares by Longji Dao, Guomei Dianqi announced a takeover of Longji Dao and indirectly obtained control of the target company. In December 2008, the target company filed a lawsuit to the High Court of Shandong Province. The plaintiff claimed the indirect takeover by Guomei Dianqi had been initiated for malicious purposes and breached relevant disclosure rules regarding the takeover of a listed company. In March 2009, the court threw out the case on the grounds that the case was filed through an incorrect procedure and thus did not meet the criteria for case acceptance.[89]

Finally, listed companies may try to revise company constitutions for the purpose of thwarting hostile takeover offers. In the hostile takeover of Aishi Gufen by Dagang Youtian, for instance, after perceiving the takeover threat, the target company management initiated two amendments to its constitution in May 1999.[90] The first amendment added a requirement of approval from the

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87 J. F. HUANG, *Baoyan Fengbo Ziben Shichang Binggou Diyi An* [Baoyan Takeover: the First Takeover in the Capital Market], China Securities Daily 1 Septembre 2008, <http://www.cs.com.cn/xwzx/01/d37/02/200809/t20080901_1571028.html>.

88 C. Z. YUE, *Sanlian Shangshe de Ziben Mozhou* [Capital Curse on Sanlian Shangshe], China Chain Store (2011).

89 山东省高级人民法院 *(Shandongsheng Gaoji Renmin Fayuan)* [High Court of Shandong Province], 民事裁定书 *(Minshi Caiding Shu)* [Civil Order], (2009) 鲁商初字 *(Lushang Chuzi 2-1)* [Commercial cases, First instance, no. 2-1].

90 H. XU, *Gongsi Fanshougou Falv Zhidu Yanjiu* [Research Report: The Regulation of Takeover Defenses] (2006) 39–40.

incumbent board for nominating new board members. Under the second amendment, the eligibility requirement was made more stringent than the statutory standard for shareholders to nominate board members: only shareholders who separately or jointly had held more than 10% of shares in the target company consecutively for more than 180 days could nominate new members to the board. The hostile acquirer filed a complaint to the CSRC against the two amendments, and the CSRC ordered that the amendments be removed.

The above four types of defensive measures have largely covered takeover defenses that can be employed by Chinese management after the emergence of hostile bids. As seen in the *Vanke vs. Baoneng* case, although the incumbent management strongly opposed the hostile takeover, they could only resort to some less fierce defensive measures such as calling in a white knight and reporting illegality to CSRC. As noted earlier, due to limits set by the relevant Chinese law, powerful *ex-post* defensive measures such as poison pills are not presently permissible in China.[91]

V. Problems and Prospects

1. Problems

To begin with, the legal framework for takeover defenses is quite vague, leaving a large grey area for many takeover defenses. The two key regulatory rules, namely the fiduciary duty of management and the Chinese board neutrality rule, have seemed in many ways to fail to clarify the legitimacy and appropriateness of takeover defenses. As a result, much room is left for defensive measures to be adopted in practice.

For instance, with respect to the restrictions on shareholders bringing forward proposals to the general meeting, particularly the proposal to nominate new board members, the current law is unclear on its legitimacy. Under Art. 103 of the 2005 Company Law, a shareholder who separately or jointly holds three percent or more of the shares can put forward proposals to the general meeting.[92] This right should cover the proposal to nominate new board members. There has been an ongoing debate on whether the company can raise the shareholding requirement above the statutory rule.[93] Further-

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[91] See *supra* Section II.2.

[92] Art. 103 2005 Company Law.

[93] TANG, *supra* note 7, 97 (arguing that Art. 103 of the 2005 Company Law is a mandatory rule and thus the company cannot deviate from it); S. W. ZHANG, 中国上市公司反收购措施的法律分析与设计：以西方常见反收购措施为中心 *(Zhongguo Shangshi Gongsi Fanshougou Cuoshi de Falv Fenxi yu Sheji: Yi Xifang Changjian Fanshougou Cuuoshi Wei Zhongxin)* [A Legal Analysis of Anti-takeover Measures in China's Listed Companies: Focused on the Common Anti-takeover Measures in the Western Countries], 公司法评论 *(Gongsifa*

more, the existing law is silent on the legitimacy of other types of anti-takeover constitutional provisions, including the staggered board provision and the provision imposing qualifications for new board members.

Second, there are loopholes in the Chinese law governing the use of takeover defenses. As discussed earlier, Art. 33 of the 2006 Takeover Measures is not applicable if the following two conditions are not satisfied: (1) takeover defenses must significantly change company assets and liabilities; (2) takeover defenses must be taken after the announcement of takeover bids. This opens the floodgate for the use of many takeover defenses. For instance, in the case of Guangfa Zhengquan discussed earlier, the defensive tactic of the white knight was used without the approval of the shareholders, because arguably the first condition was not satisfied, that is, the defense did not significantly change the assets, liabilities, entitlements and business performance of the target company. Similarly, in the case of ST Meiya discussed earlier, the target management did not obtain the shareholders' approval to use the defense of wining support from relevant stakeholders, due to the absence of the second condition: technically, the defense was adopted before the announcement of a takeover bid.

Apart from the defects in the legal provisions, the lax enforcement of the law by the regulator is also a contributing factor to the widespread adoption of takeover defenses. In some cases, it has been reasonably clear that the adoption of takeover defenses is in violation of the law, but the CSRC has not taken actions against it. For instance, the constitutional provision empowering the board of directors to take defensive measures without getting approval from shareholders runs afoul of the law for takeover defenses. As discussed earlier, under Chinese company law, the general meeting, rather than the board of directors, has the power to decide on major issues, including takeovers. More specifically, Art. 33 of the 2006 Takeover Measures requires the approval of shareholders for certain types of *ex-post* defenses. Furthermore, serious doubt can be cast onto the legitimacy of the constitutional provision requiring approval from the board of directors for share acquisitions above certain thresholds. This is because it is a fundamental right of shareholders of listed companies to freely transfer their shares, subject to relevant disclosure requirements.

It should be noted that in recent months, stock exchanges and the CSRC have begun to make enquiries and hold regulatory meetings on the use of takeover defenses. After regulatory intervention, some companies withdrew their motions to pass their anti-takeover constitutional provisions, while others insisted on their plan. For instance, in December 2015, a Shenzhen-listed company called Longping Gaoke proposed revising its constitution to intro-

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Pinglun) 1 (2007) 127 (contending that it is lawful and desirable for the company to raise the nomination criteria).

duce restrictions on the shareholder right to nominate directors. On 13 January 2016, Shenzhen Stock Exchange sent a query letter to the company, asking if there was any legal basis for introducing those proposed provisions. Two days later, Longping Gaoke dropped the proposal. But some other companies, such as China BaoAn and Bai Lilian, refused to give up their anti-takeover provisions after receiving query letters from stock exchanges, arguing that those provisions are necessary to fend off bad-faith takeovers. In May 2018, a district court in Shanghai handed down a judgment ruling that it is illegal to add a further requirement of holding shares for more than 90 days for the exercise of the right of putting forward proposals.[94] As the first court judgment on the legality of anti-takeover constitutional provisions, the case was brought as a public interest suit by an investor protection agency under the leadership of the CSRC. More such cases are needed to shed light on the use of takeover defenses in China.

In summary, there is a need for the CSRC or stock exchanges to set out clearer standards on the illegality of anti-takeover constitutional provisions and enforce them with more rigor through more formal tools. Furthermore, if such standards are set out, they should apply to all anti-takeover constitutional provisions currently in use.

2. *Prospects*

As noted above, it is important to improve the regulation of takeover defenses in China, but the difficult question is how to go about doing so, given the particular context of China's local conditions.

As a general principle, the law needs to take a balanced approach in regulating anti-takeover constitutional provisions. Some commentators have argued that to facilitate takeovers in China, all *ex-ante* takeover defensive provisions should be strictly prohibited.[95] This suggestion of a blanket ban needs to be treated with caution. Although China should encourage takeover activities to obtain various benefits such as efficient allocation of scarce resources, a mechanism for monitoring corporate management, etc., one should not push this inclination to an unlimited extreme without consideration of the potential harms associated with takeovers. In fact, takeover defenses could be properly used by target management for the benefit of shareholders to thwart some genuinely undesirable takeovers.

Furthermore, in a contested takeover some defenses could be employed to instigate an auction, which would get the shareholders the highest possible

[94] 上海市奉贤区人民法院 *(Shanghaishi Fengxianqu Renmin Fayuan)* [People's Court of Fengxian District of Shanghai Municipality], 民事判决书 *(Minshi Panjue Shu)* [Civil Judgment], (2017) 沪0120民初13112号 (Hu0120, Civil case, First instance, no. 13112).

[95] See e.g. W. CAI, Hostile Takeovers and Takeover Defences in China, Hong Kong Law Journal 42 (2012) 1, 34.

price for their assets.[96] Even assuming that the target's management will act in a self-interested way, some commentators have argued that some, but not all, target stock buybacks may increase shareholder wealth as a result of the instigated auction.[97] Statistical data have shown that the takeover premiums paid for US companies are higher than those paid for European companies, which suggests that the widely used defenses in the US could raise the premiums for the shareholders.[98] Still, there is leeway for the use of defensive tactics to benefit shareholders, leaving the indiscriminate prohibition of defensive measures as too simplistic a remedy.

Thus, the issue of how to regulate takeover defenses needs to be handled carefully to strike a delicate balance between eliminating the abuse of defenses yet at the same time preserving the use of defenses for proper purposes. Indeed, encouraging takeovers to increase company value and monitor management must be balanced with protecting the interests of shareholders. A fair and just process should maintain economic efficiency during the takeover process and prevent corporate raiders or other parties from harming the rights of other shareholders. The expropriation of wealth by some parties not only harms other shareholders but also decreases the incentive to invest by increasing risk. On the other hand, defensive measures should not be used to the effect of causing insurmountable barriers for hostile takeovers.

VI. Conclusion

The regulation of takeover defenses has recently become a focus of research in China due to the rise of hostile takeovers in the Chinese securities markets. From a comparative perspective, the Chinese legal regime for takeover defenses seems to be a mixed legal transplantation of relevant experiences in the US and the UK. Recent developments, however, show that the regime has

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[96] See e.g. L. A. BEBCHUK, The Case for Facilitating Competing Tender Offers, Harvard Law Review 95 (1982) 1028 1034–1038; R. J. GILSON, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defenses, Stanford Law Review 35 (1982) 51.

[97] M. BRADLEY/M. ROSENZWEIG, Defensive Stock Repurchases, Harvard Law Review 99 (1986) 1377; J. R. MACEY, F. S. MCCHESNEY, A Theoretical Analysis of Corporate Greenmail, Yale Law Journal 95 (1985)13. But see J. N. GORDON/L. A. KORNHAUSER, Takeover Defense Tactics: A Comment on Two Models, Yale Law Journal 96 (1986) 295 (arguing that the target stock buybacks are unlikely to increase shareholder wealth as a general matter).

[98] KIRCHNER/PAINTER, *supra* note 17, 379–381. But see F. H. EASTERBROOK/D. R. FISCHEL Auctions and Sunk Costs in Tender Offers, Stanford Law Review 35 (1982) 1, 8 (arguing that diversified shareholders who own both bidder and target company stock should be indifferent to bid price maximization).

problems both in terms of the clarity of relevant provisions and of the enforcement efforts by the regulator.

The recent high-profile case of *Vanke vs. Baoneng* has illustrated the importance of takeover defenses, triggering a flurry of efforts by many listed companies to adopt anti-takeover constitutional provisions to repel potential hostile takeovers in the future. There are a wide variety of such provisions, many of which have uncertain legal status under current Chinese law. Apart from *ex-ante* defenses, *ex-post* defenses also present regulatory challenges. It is imperative that the regime be improved so as to provide a sound legal basis for the use of takeover defenses and ultimately for the functioning of hostile takeovers in China.

Pre- and Post-Bid Defenses in Korea

Overview and Recent Doctrinal Development

Ok-Rial Song

I. Introduction

It has been widely accepted in efficiency-oriented corporate law academia that the rules on hostile takeovers and defensive measures aim to enhance social efficiency mainly by protecting target company shareholders. Efficiency matters in two contexts. On the one hand, an inefficient bidder often attempts to acquire a target company. In such a case, tender offer regulations, mandatory bid rules, and the target company's defensive tactics are designed to stop such inefficient acquisition from occurring. On the other hand, the target's value is often increased if the current incumbent management is displaced by an efficient hostile bidder.[1] In such a case, however, the incumbent management is likely to insist on retaining control, and therefore takeover rules should prevent such target managers from launching defensive tactics. As a result, social efficiency can be achieved by encouraging such an efficient takeover to take place.

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[1] H. G. MANNE, Mergers and the Market for Corporate Control, Journal of Political Economy 73 (1965) 112–113 (creating the notion of a market for corporate control).

The rules on takeover defenses, therefore, are relevant in both contexts. They should deter inefficient bidders and at the same time encourage efficient ones. In other words, the desirable rule should permit the target's incumbent managers to defend against a hostile bidder if and only if the bidder is inefficient. The problem, which has been commonly observed elsewhere in corporate law, is that the incentive of the target managers is likely to diverge from such criteria. The incumbent managers tend to be exceedingly defensive and have incentives to launch defensive tactics even against efficient bidders.[2] Such an agency problem becomes even worse when the target managers are superior to the target shareholders in determining whether or not a specific bidder is efficient. In most hostile takeover disputes, for instance, the target shareholders could not verify whether or not the allegedly harmful acquisition might end up actually hurting the target's long-term profitability. Thus, a conventional approach of corporate law – the shareholders' intervention in such decision – is not a perfect fit for this problem. Such trade-off between informational advantage and the incentives of the target management is the primary source for the different global approaches toward regulating defensive tactics.[3]

Hostile takeovers, however, have been very rare in Korea. Even the companies whose shareholders are publicly dispersed have barely been subject to the attempts of hostile bidders. Tender offers, which are a main tool to acquire target shares in the U.S. or the U.K. market, have been mostly used for the purpose of delisting the company or reshuffling the corporate group into a holding company structure. It has not been used for hostile takeovers. Several recent high-profile cases which were labeled as hostile takeovers by news media were just disputes in which foreign activist shareholders or hedge funds demanded that the companies consider their proposals.[4] They did not attempt to acquire the target shares. As a result, Korean corporate law has had very few chances to develop legal doctrines relating to defensive tactics. The courts, for instance, still seem to adopt a "primary purpose test" in examining the validity of a defensive issuance of new shares to a white knight. They are unlikely to examine whether the characteristics and intention of the bidder or other business circumstances could justify the use of defensive measures. Even worse, several defensive tactics, which were commonly adopted elsewhere in the world, turn out to be unavailable under Korean corporate law. A poison pill, for instance, is not allowed, and a staggered board does not work. Arguably, the lack of hostile

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[2] *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 954 (Del. 1985) (the ruling highlighted "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders").

[3] R. KRAAKMAN et al., The Anatomy of Corporate Law: A Comparative and Functional Approach (3rd ed., Oxford 2017) 211–212.

[4] See *infra* Section II.3.a).

takeovers – its reason still being in doubt – partly accounts for such an underdevelopment of legal doctrines on defensive tactics.

Against this backdrop, this paper approaches the issue from more theoretical perspectives and examines the current stage of Korean corporate law on takeover defenses. In particular, three claims are stressed in this paper. First, it should be discussed whether it is at all socially desirable to allow the target management – they are often themselves controlling shareholders in Korea's big listed companies – to defend against hostile takeovers when the unique ownership structures are taken into account. To be sure, it has been argued that the incumbent management's power to adopt takeover defenses often brings several efficient outcomes, ex-ante as well as ex-post, stemming mainly from overcoming the information asymmetry between management and dispersed shareholders.[5] Such asymmetry, however, is typically observed in dispersedly-owned companies in the U.S. When it comes to a Korean corporate group, conversely, the controlling shareholders are successfully able to keep an eye on the managers, and thus the size of the information asymmetry, if any, tends to be relatively small. In such case, therefore, it can hardly be argued that multiple social benefits can be achieved by giving target management the power to launch defensive tactics.

Second, it should be carefully examined what measures are currently available for defensive tactics under Korean corporate law. Several listed companies may be subject to the threat of hostile takeovers. A significant number of the listed companies in the Korean stock market, for instance, are dispersedly owned. Even in the companies affiliated with a corporate group, a controlling family and its related parties often own only a small fraction of shares, with more than half owned by public or foreign shareholders. They might need defensive measures if the threats turn out to be real.[6] The defensive tactics, however, are hardly applicable to those companies. For instance, staggered boards, dual class shares, and, most importantly, poison pills are not available under Korean corporate law. It appears to be interesting that such unavailability is not the result of policy discussions, and in fact it came from a rather rigid interpretation of the relevant provisions in corporate law. In that sense, Korean corporate law jurisprudence should become more flexible.

Finally, this paper briefly addresses the question of how strongly defensive tactics should be designed, especially in relation to poison pills. They can – like the U.S.-style poison pill – be so powerful as to block most hostile attempts, or, by contrast, they can remain so weak as to be almost useless against ordinary hostile takeovers. This question should not be confused with the first question as to whether management should be allowed to defend against hostile takeo-

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[5] See *infra* Section II.2.

[6] This is merely a theoretical possibility, and, in fact, the control of the big Korean companies has almost never been contested. See *infra* Section II.3.a).

vers. Recently, the Ministry of Justice of Korea attempted to introduce a U.S.-style poison pill, but many commentators – from both law and finance – claimed that a poison pill should not be allowed because it would inevitably paralyze the corporate control market in Korea. It was not clearly stated, however, whether only a "strong" version of poison pill was rejected, thereby admitting the necessity of modest defensive measures. What was missing in that discussion was an appreciation that the power of a poison pill can vary depending on the design of the plan. The allocation of the burden of proof, the requirement of a shareholder meeting to approve the defensive measures, and mandatory review by independent authorities are obviously relevant to determining the power of a poison pill. They can be set by statutory mandatory rule or by judge-made law. Currently, however, very few court cases are available in Korea in relation to the standard of judicial scrutiny on defensive measures. The Korean Supreme Court has not dealt with the question of when defensive measures can be legitimately launched, and even trial court decisions are very few. Further development is needed in this respect.

II. Suspect Benefits of Takeover Defenses in Korea

1. Market for Corporate Control

According to the notion of a market for corporate control, the possibility of hostile takeovers – and as a result the incumbent management's losing control over the target – is regarded as one of the strategies for reducing the agency costs of a target firm under a dispersed ownership structure. On the one hand, it actually transfers corporate assets from the current inefficient management to an efficient hostile bidder and thereby achieves *ex-post* efficiency. Even if no hostile takeovers are attempted, on the other hand, it still achieves *ex-ante* efficiency by threatening target managers so as to increase shareholder value. Unless hostile takeovers significantly lower the acquirer's firm value, they are fairly said to be socially desirable, which has been supported by a considerable amount of empirical evidence.[7] Arguably, this contention leads to the conclusion that takeover defenses, which have an effect of paralyzing such market for corporate control, are highly likely to reduce the target firm's shareholder value and ultimately end up hurting social efficiency.

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[7] M. BRADLEY/A. DESAI/E. H. KIM, Synergistic Gains from Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms, Journal of Financial Economics 21 (1988) 3 (31.77% for target, 0.97% for acquirer, 7.43% combined); H. SERVAES, Tobin's Q and the Gains from Takeovers, Journal of Finance 46 (1991) 409 (23.64% for target, –1.07% for acquirer, 3.66% combined); S. N. KAPLAN/M. S. WEISBACH, The Success from Acquisitions: Evidence from Divestitures, Journal of Finance 47 (1992) 107 (26.90% for target, –1.49% for acquirer, 3.74% combined).

In fact, it was renowned scholars F. H. EASTERBROOK and D. R. FISCHEL who more than three decades ago strongly advocated this claim.[8] Simply put, since hostile takeovers are desirable from the perspectives of both target shareholder value and social efficiency, defenses against them are undesirable in most cases. It is not necessary, the argument goes, to prove that "the sky is blue." It is too obvious that the availability of defensive measures hurts the shareholder value of the target firm. Unless other social benefits, if any, are found to offset the decline in shareholder value, defenses against hostile takeovers should, in principle, be prohibited or at a minimum be strictly scrutinized. Interestingly enough, it was not Delaware corporate law but the EU Takeover Directive across the Atlantic Ocean that followed this recommendation.[9]

2. *Benefits of Takeover Defenses: Theory*

When a child grows up, however, he or she comes to know that the air in the sky is not blue-colored. Yet this is not that obvious and should be subject to empirical investigation. Similarly, economic theory offers countervailing stories as to why takeover defenses are actually able to increase the shareholder value of the target firm and social efficiency as a whole. There are at least four arguments which purport to show that defensive measures are used to enhance the target's shareholder value.

First, the *bargaining hypothesis* argues that target managers use defensive measures to increase their bargaining power, and thus they are able to negotiate a higher acquisition price or more favorable conditions in selling the company.[10] It is worth noting, however, that this assertion looks merely at distribution of wealth rather than social efficiency itself. Even if a higher premium is paid to target shareholders, this benefit is exactly offset by the losses of shareholders of the acquiring company. Thus, it is still questionable whether defensive measures are socially acceptable. On top of that, such bargaining power enhancement is likely to have an inefficient *ex-ante* effect. If a higher acquisition price is expected, for instance, it creates a perverse incentive for an acquirer to be more reluctant in searching for target candidates because the expected gain from hostile acquisition declines. Therefore,

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[8] F. H. EASTERBROOK/D. R. FISCHEL, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harvard Law Review 94 (1981) 1161; F. H. EASTERBROOK/D. R. FISCHEL, Takeover Bids, Defensive Tactics, and Shareholder Welfare, Business Lawyer 36 (1981) 1733.

[9] Directive 2004/25/EC, Arts. 9.2 and 12.1 (no frustration rule and board neutrality).

[10] E. BERKOVITCH/M. BRADLEY/N. KHANNA, Tender Offer Auctions, Resistance Strategies and Social Welfare, Journal of Law, Economics, and Organization 6 (1989) 395; R. STULZ, Managerial Discretion and Optimal Financing Policies, Journal of Financial Economics 26 (1990) 3; E. BERKOVITCH/N. KHANNA, How Target Shareholders Benefit from Value-Reducing Defensive Strategies in Takeover, Journal of Finance 45 (1990) 137.

according to the notion of a market for corporate control, the decreased number of attempted hostile takeovers hurts social efficiency.

Second, it is perhaps *pressure to tender* or *informational advantage* that is the most conventional argument supporting the target board's adopting defensive measures. Shareholders are often subject to a pressure to tender problem even if the bidder is inefficient – or where it is an "abusive or destructive bidder" as in the recent "Bull-Dog Sauce" ruling in Japan.[11] Such a bidder may destroy corporate value or pursue excessive private benefits, but shareholders cannot help selling their shares due to a prisoner's dilemma. In such a case, it has been recommended that the sale of shares by target shareholders be the result of collective rather than individual decision making.[12] Alternatively, however, target managers protect target shareholders by launching defensive measures against such an inefficient bidder. Compared to the collective decision making of shareholders, the option of takeover defenses is more viable, particularly when such information about a specific bidder's intention and capability is available only to the target managers. Although it still needs empirical support, the managers' informational superiority over shareholders in dealing with hostile tender offers has been most conventionally raised when it comes to takeover defenses.

Third, it has been argued that the *short-termism* or *myopia* problem of top management can be mitigated if takeover defenses are allowed.[13] It has been reported that managers in big listed companies often show a tendency toward more emphasis on short-term profits. It is, however, not because they are short-sighted. Rather, it is market investors that demand short-term profits. When the target company is dispersedly owned, even managers with long-term vision cannot find a way to credibly deliver this perspective to shareholders, and thus information about profitable long-term investment opportunities is not easily transmitted to the stock market. As a result, such a firm ends up being undervalued, and the possibility of hostile takeover is increased. Simply put, the operative market for corporate control prevents the target management from having long-term prospects, and is thus likely to hurt long-term shareholder value. The flip side of this reasoning is that insulation

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[11] J. ARMOUR/J. B. JACOBS/C. J. MILHAUPT, The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework, Harvard International Law Journal 52 (2011) 255–257.

[12] L. A. BEBCHUK, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, Harvard Law Review 98 (1982) 1695; L. A. BEBCHUK, The Pressure to Tender: An Analysis and a Proposed Remedy, Delaware Journal of Corporate Law 12 (1987) 911.

[13] J. C. STEIN, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, Quarterly Journal of Economics 104 (1989) 655; A. SHLEIFER/R. W. VISHNY, Equilibrium Short Horizons of Investors and Firms, American Economic Review 80 (1990) 148; K. A. BORKHOVICH/K. R. BRUNARSKI/R. PARRINO, CEO Contracting and Antitakeover Amendments, Journal of Finance 52 (1997) 1495.

from such threat – by allowing takeover defenses – will help managers pursue long-term goals despite the risk of an undervaluation of the target stock.

Finally, insulation of management encourages them to make *relationship-specific investments,* which refers to valuable human capital only in relation to a particular company or a particular industry. Such relationship-specific investments are also subject to the general principle of investment, which compares the cost and the return associated with the investment. One of the most important elements in determining the return is the length of employment, because the residual value of the relationship-specific investment would be zero if the relationship – employment – disappears. Consequently, if the threat of hostile takeover is significant, the expected return from the managerial relationship-specific investment decreases, which inevitably leaves managers less willing to incur the initial costs of such investment. Perhaps such reduction of relationship-specific investments harms social efficiency as well as the target's shareholder value.

Defensive measures weaken the market for corporate control. At the same time, however, they are likely to increase shareholder value in target companies with dispersed ownership and as a result enhance social efficiency by discouraging an inefficient bidder from attempting acquisition, by mitigating managerial myopia, and by encouraging management to make relationship-specific investments. In addition, defensive measures benefit the target shareholders by increasing the acquisition price. Such benefits should be weighed against the costs. If such benefits are larger than the costs of paralyzing the market for corporate control, it could be socially desirable to allow takeover defenses.

3. Benefits of Takeover Defenses: Realities in Korea

a) Has a Threat of Hostile Takeovers Ever Existed?

The multiple social benefits identified above can easily be found if the target is dispersedly owned. A few listed companies in Korea, including in particular financial holding companies, have such an ownership structure, and takeover defenses in those companies are likely to enhance long-term shareholder value. Most big listed companies, however, belong to conglomerate groups which are controlled by a controlling family.[14] The families maintain their control over the groups through a complicated circular shareholding or pyramid structure, and thus the level of direct ownership – corresponding to cash-flow

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[14] The Korea Fair Trading Committee (hereinafter "KFTC") annually designates the "regulated corporate group" for the purpose of applying corporate group regulation. In 2016, for instance, among 65 regulated corporate groups, 45 groups have controlling families. Considering that 12 groups are owned by governmental agencies, dispersed ownership is found only in 8 non-governmental corporate groups. KFTC, press release, 7 July 2016, at 1.

rights – by the controlling families is generally very low.[15] In 2016, for instance, among 45 corporate groups with controlling families, the average level of direct ownership by controlling families was only 4.1%, while the average level of ownership by group-affiliated companies was 50.6%.[16] In the 10 largest corporate groups, things were even worse. Controlling families directly owned only 2.6%, but exercised control over 54.9% of the shares owned by affiliated companies.[17] With such indirect ownership by group-affiliated companies, corporate control arguably cannot be contested. Indeed, even though such controlling families are just minorities in terms of direct ownership, they seem to succeed in maintaining uncontested control over the groups.

In the hostile takeover context, however, one caveat should be noted. Those numbers were merely an average. All the group members are not perfectly insulated from hostile takeover. In the Samsung Group, for instance, affiliated companies own on average 46.36% of the group members, but such ownership of Samsung Electronics is only at 12.72%.[18] Since 68.91% is owned by non-affiliated investors, Samsung Electronics can be fairly said to be subject to a takeover threat. As for other big companies (considering a few as examples), ownership by affiliated companies in comparison to ownership by outside investors is at 16.88% versus 78.32% for Hotel Shilla, 18.89% versus 79.48% for Samsung Engineering, and 23.69% versus 73.61% for Samsung Electro-Mechanics. It is *theoretically* possible for these companies to be a target, but how often has their corporate control been contested in actuality? *Almost never.*

Maybe these companies are too big to be subject to hostile takeover. It has long been argued, however, that management of those listed companies should be allowed to defend against hostile takeovers, since the controlling shareholders are often minority shareholders in terms of direct ownership. In particular, the Korean stock market is widely open to foreign investors, and such foreign ownership accounts for more than 30% of market capitalization. The business sectors therefore have been concerned about foreign activist funds attempting to acquire the "national champion" companies, and as a result they have argued for allowing defensive tactics. It is not that obvious, however, whether these concerns are legitimate. Before moving on to next stage of analysis, it is worthwhile to respond briefly to this "attack by foreign investors" argument.

First, as stated above, almost no hostile tender offers have been attempted by foreign investors so far. In particular, control over the "national champion"

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[15] O. SONG, The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reform in Korean Chaebol, Law & Policy in International Business 34 (2002) 196–201.

[16] KFTC, *supra* note 14, at 1.

[17] *Id.*

[18] KFTC, *supra* note 14, at Appendix 4.

companies has not yet been challenged. Even the U.S. hedge funds have not attempted to acquire shareholdings large enough to control these companies, and there is no indication that they will do so in the near future. Second, media uses the term "hostile takeover" with a different meaning. Foreign investors often acquired a significant amount of a company's shares – but not enough to acquire its control – and then made a shareholder proposal or an unofficial suggestion to increase shareholder return, and news media and commentators tended to label it as a "hostile takeover" rather than "shareholder activism." This is merely one of the strategies and techniques that international investors or hedge funds have ordinarily employed to engage in corporate affairs, and it has nothing to do with the market for corporate control. Finally, foreign investors – whose equity investments, on average, account for more than 30% of the Korean stock market – focused on only a few large companies. In the Samsung Group cases, for instance, foreign ownership of Samsung Electronics was 50.69% on 12 March 2017, but it was merely 11.66% for Hotel Shilla, 12.90% for Samsung Engineering, and 16.88% for Samsung Electro-Mechanics. That said, most listed companies in Korea are arguably still on the safe side in respect of takeover threats by foreign investors.

b) Analysis: Benefits of Takeover Defenses?

Controlling families now exercise effective control over the group firms, and even in the group firms in which the ownership is diversified among public investors, control does not appear to be contested. Since control was already insulated, it is very unlikely that additional social benefits can be created by allowing takeover defenses. Moreover, even if the control of controlling families is somewhat vulnerable and there is a real threat of hostile takeover by foreign investors, it does not necessarily support adopting takeover defenses. In other words, the several social benefits associated with takeover defenses would hardly be obtained, since it is not the incumbent management but the shareholders themselves that exercise control in such concentrated ownership systems. Again, such a different pattern of corporate ownership plays a critical role in assessing the social benefits of takeover defenses. To examine this argument, let us return to the social benefits mentioned above.

First, in a dispersed ownership structure, target managers holding takeover defenses negotiate a higher tender offer price on behalf of all the target shareholders. Similarly, it might be argued that, in a concentrated ownership structure, controlling shareholders play the same role and thus takeover defenses may help them. This is not convincing, however. The crucial difference in a concentrated ownership structure is that, even if a new buyer succeeds in acquiring enough shares from the market to outnumber the existing controlling shareholder, it is almost impossible to expel the current controlling shareholder unless he or she voluntarily quits. A new buyer's control of the entity will not be stable as long as the old controlling shareholder remains as a second largest shareholder. A new buyer, therefore, is unwilling to pay a higher premium to public shareholders and normally negotiates with a controlling shareholder to buy his or her control block. In such a case, defensive measures function differently; namely, they help controlling shareholders negotiate a higher premium for themselves and not one enjoyed by the other public shareholders.

Second, neither does the pressure to tender or the information advantage argument hold in the concentrated ownership system since it is relatively unlikely that inefficient or value-destroying hostile takeovers are actually attempted. This argument assumes that an inefficient bidder is still willing to acquire a control block of the target by paying more than the current market price for the purpose of pursuing excessive private benefits. Thus, the expectation of obtaining huge private benefits is the primary source that enables the occurrence of inefficient or value-destroying takeovers. Here again, however, a new buyer is not comfortable in pursuing private benefits unless the current controlling shareholder leaves the target firm. He or she still owns enough significant shares to disturb a new buyer and does not need defensive measures in order to do this. It may reduce the buyer's expected payoff from acquiring the target, and thus such an inefficient bidder will abandon launching a hostile tender offer. There is no social benefit in resolving the pressure to tender problem because no such problem arises in a concentrated ownership system.

Third, the short-termism argument may be of limited use simply because, again, controlling shareholders are unlikely to be displaced by the stock market. According to the short-termism narrative, managers are reluctant to pursue long-term investments because such information cannot be communicated to the stock market and thus the market will punish such managers. In the case of companies with controlling families, however, short-termism is unlikely to be a problem. There are basically two reasons: (1) It is still plausible that market investors are short-sighted, and the information about long-term investments is hardly communicated to such minority shareholders. In such a case, the company is likely to be undervalued. A controlling shareholder, however, is not concerned about this – relative to professional management in a dispersed ownership structure – because he or she is not removed by other shareholders. To understand this argument, imagine that a potential buyer finds out that the target is now undervalued. He or she will possibly launch a tender offer, acquire controlling shares, and change the investment strategy. What happens, then, to the previous controlling shareholders? They may lose their private benefits, but they benefit from the increase in the stock price. In this respect, therefore, market undervaluation and as a result the possibility of losing control may not be very detrimental to the controlling shareholders' interest. (2) In fact, controlling shareholders in the big Korean conglomerates already have a long-term horizon since control is very often bequeathed to future generations. They have an incentive to pursue the long-term sustainability of their conglomerates rather than to obtain short-term profits. Since long-term efficiency is already borne in mind by controlling shareholders, who are in any event not vulnerable to market pressure, allowing takeover defenses creates few, if any, additional benefits.

Finally, the firm-specific investment argument is still applicable to the case of controlling shareholders. The more stable their control is, the higher the level of firm-specific investments they will make. Thus, takeover defenses surely reinforce the tendency toward making firm-specific investments by controlling shareholders and management. There are two caveats, however: (1) As mentioned above, controlling shareholders' control in the big Korean conglomerates is highly stable and has never been contested, which means the level of firm-specific investments was already high. Thus, the magnitude of marginal increase associated with such an investment as results from allowing takeover defenses may be negligible. (2) As for the investment on the management side, there is still the possibility that the threat of hostile takeovers will have little impact on it. While unfriendly acquisition of a target having dispersed ownership almost always results in a change of management, hostile acquisition of a target having controlling shareholders often aims to eliminate only the controlling shareholders. It does not necessarily end up removing the existing management since a new bidder often needs the expertise of the current professional management.

In conclusion, it is not convincingly argued that defensive measures are likely to enhance shareholder value or social efficiency in Korean conglomerate groups, regardless of whether the controlling shareholders hold a majority or minority of shares in each company. The very existence of controlling shareholders already limits hostile takeovers, and thus allowing takeover defenses will hardly create additional social benefits. Even if such control is a bit vulnerable, few social benefits can be added by allowing defensive measures. Arguably, the current problem in the Korean stock market is not a devastating level of threat posed by hostile takeovers but the lack of such a threat. The possibility of hostile takeovers can serve as an important mechanism to reduce agency costs associated with controlling shareholders in Korean conglomerates. F. EASTERBROOK and D. FISCHEL might be right. In Korea, it turns out that the sky is indeed blue.

III. Defensive Measures under Korean Corporate Law

1. Overview

What defensive measures are available under Korean corporate law? Like other developed jurisdictions, the Korean Commercial Code (hereinafter: KCC), in which corporate law is codified, does not have any explicit provisions on takeover defenses. Although hostile takeovers have been very rare and thus the court has had few opportunities to evaluate the use of defensive measures, commentators have discussed the availability of several defensive measures, all of which were typically developed in U.S. law.

Compared to Delaware corporate law, the most interesting feature of Korean corporate law is that the most popular tactics endorsed by the Delaware courts are in fact unavailable. Poison pills, which have been heavily used in the U.S. market, for instance, are not allowed under the KCC, because a company is prohibited from issuing a stock option independently.[19] Staggered boards, which have been a powerful shark repellant in Delaware corporate law, are not effective in Korea since directors can be removed at any time without cause,[20] regardless of whether or not they are staggered – the articles of incorporation cannot provide otherwise. Dual-class shares and golden shares, which have been widely used in many U.S. and European companies, are unlawful under the KCC since they violate the one-share-one-vote principle.[21] A company is prohibited from issuing new shares or convertible bonds to a friendly third party if the purpose is to defend against hostile takeovers.[22] Taken together, it can be fairly said that the typical and powerful defensive measures are not allowed in Korea.

Why are they prohibited under the KCC? The striking fact is that they are very rarely prohibited based on anti-defense legal policy.[23] One such rare example is the poison pill. A decade ago, the Ministry of Justice proposed a draft to intro-

[19] See *infra* Section III.4.c).

[20] Art. 385 para. 1 KCC.

[21] Art. 369 para. 1 KCC.

[22] Korean Supreme Court 2008 Da 50776, 30 January 2009; Seoul High Court 97 Ra 36, 13 May 1997.

[23] The notable exception is a trial court decision issued more than a decade ago. In the case at issue, a company undertook a large-scale public offering of new shares for a defensive purpose, and the court held that the question of whether such action is permissible should be determined by taking into account the totality of circumstances, including, to name a few, the motivation or purpose behind the defense, the reasonableness of launching the defense, the corporate culture of the target company, the social meaning of the target's business, the impact on the interest of the company and shareholders, and the adequacy of the procedure. Suwon District Court Yeoju Branch 2003 Kahap 369, 12 December 2003. The court decision took into account the Unocal standard under Delaware law, but the approach has almost never been followed since then.

duce a poison pill plan,[24] but it was explicitly opposed by many legislators and commentators for the reason that such plan was likely to hurt the market for corporate control. Such discussions have been very rare, however, in relation to other defensive tactics. Most measures have been unavailable simply because they are inconsistent with allegedly mandatory rules in the KCC. A staggered board, for instance, is deemed to infringe upon one of the fundamental shareholder rights – appointment and removal of board members. Dual-class shares violate the one-share-one-vote rule, which is regarded as mandatory in Korean corporate law. The issuance of new shares is merely a tool to raise new capital, and thus it should only be utilized as such. Arguably, such inflexible and narrow interpretations have been prevalent in the KCC, and thereby defensive measures are treated differently than under Delaware law.

As a result, the sale of treasury shares to a third party or a white knight has been the most feasible option that target management can adopt against the threat of hostile takeover. In fact, many big listed companies buy back their own shares and keep them as treasury shares in order to sell them in an emergency to a friendly white knight. It is worthwhile to note, however, that the popularity of stock buybacks does not seem to be based on a correct understanding of the nature of a sale of treasury shares. As mentioned above, the Supreme Court has prohibited a company from issuing new shares to a third party for a purely defensive purpose, but, conversely, another trial court held that sale of treasury shares is allowed even if the purpose is solely defensive. Where does such asymmetry come from? In fact, the trial courts have held that a sale of treasury shares should be treated differently from issuance of new shares, primarily because their economic substance is different.[25] Such an understanding is wrong, however. The sale of treasury shares is equivalent to a cancelation of treasury shares followed by issuance of new shares. Thus, if the court takes into account economic substance correctly, the sale of treasury shares and the issuance of new shares to a third party should be subject to the same regulation. If this were to happen, however, the KCC would come to face a new problem whereby almost no defensive measures would be available.

2. *Pre-Bid Measures*

The articles of incorporation of the target often prevent a hostile bidder from acquiring the target quickly. These provisions are sometimes referred to as "shark repellants" in U.S. law. These defensive measures recall an amend-

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[24] See *infra* Section III.4.c).

[25] Suwon District Court Sungnam Branch 2007 Kahap 30, 30 January 2007; Seoul North District Court 2007 Kahap 1082, 25 October 2007; Seoul Central District Court 2015 Kahap 80579, 7 July 2015. But at least one trial court decision treated both transactions equivalently. See, for instance, Seoul West District Court 2006 Kahap 393, 24 March 2006.

ment of the articles of incorporation, and thus it is necessary to acquire the consent of other minority shareholders in advance. As stated above, however, almost no pre-bid measures are currently available under the KCC.

a) Supermajority Voting Requirement

The KCC provides commonly-observed voting rules on shareholder approval. An ordinary resolution requires a majority of the votes present at the shareholder meeting, which should at the same time account for no less than one-fourth of the total number of voting shares.[26] A special resolution, on the other hand, is to be passed by no less than two-thirds of the votes present at the meeting and should at the same time be no less than one-third of the total number of voting shares.[27] These requirements can be enhanced by the articles of incorporation.[28] In fact, several listed companies in Korea have adopted supermajority voting requirements in their articles of incorporation, by which a number of votes greater than that of a special resolution is required for transactions that result in the transfer of corporate control. In particular, the removal of current directors is typically subject to such a supermajority vote in those companies. The supermajority vote is in effect equivalent to granting veto power to minority shareholders, and thus it will be difficult for a hostile bidder to exercise complete control after acquiring the target. Supermajority vote provisions often can be deleted or amended only by a vote equal to the same supermajority vote. Amending a 90% vote requirement, for instance, requires approval by no less than 90% of the total outstanding shares.

Notwithstanding the fact that such provisions are found in the articles of incorporation of a few listed companies, the validity of a supermajority vote requirement is not firmly established under the KCC. Although one trial court once held that a supermajority vote provision for removal of directors was invalid,[29] the judges generally tend to be reluctant to invalidate such provisions because such contractual freedom seems to be explicitly granted by the KCC. Commentators, however, have strongly argued that such an excessive supermajority vote should be invalidated, since granting a veto power to minority shareholders violates the general principle of decision making in corporate law. They argue that corporate decisions should be made by the majority, not minority, of the voting shares. It is not clear, however, whether such principle has ever existed in Korean corporate law. Moreover, this argument seems to ignore that such veto power is provided by the articles of incorporation, which means the majority of shareholders already negotiated for such a

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[26] Art. 368 para. 1 KCC.

[27] Art. 434 para. 1 KCC.

[28] Art. 368 para. 1 KCC ("Unless otherwise provided in the KCC or the articles of incorporation").

[29] Seoul Central District Court 2008 Kahap 1167, 2 June 2008.

provision. The commentators fail to provide convincing arguments on why we should be concerned about such *ex-ante* negotiations between shareholders.

b) Staggered Boards

The staggered board as a defensive scheme is distinctive in Delaware corporate law. The typical arrangement is to divide the board of directors into three classes, of which only one is elected annually. Thus, even if a bidder succeeds in acquiring the target, it would take at least another one or two years to completely fill the board with his or her own appointments. In U.S corporate law, the staggered board is even more powerful when it is combined with a poison pill plan because it restricts the availability of a proxy fight to acquire the target.[30]

A few listed companies in Korea have actually adopted a staggered board, and classification into three classes is common. Unlike its U.S. counterpart, however, a staggered board in Korea puts more emphasis on the continuation of board rather than a defensive function against hostile bids. In fact, a staggered board cannot work as a defensive measure because a successful hostile bidder is still able to fill the board as soon as he or she acquires enough target shares to remove directors. In other words, he or she does not have to wait for several years. Under the KCC, directors may be removed any time, with or without cause, by passing a special resolution at a shareholder meeting.[31] A director removed without cause before the expiration of his or her term is only entitled to compensation for damages caused by such removal.[32] Articles of incorporation which stipulate otherwise are invalidated because the rights concerning appointment and removal of directors belong to the fundamental rights of shareholders, which should be valued more than freedom of contract. A staggered board arrangement is not an exception.

This is a crucial difference compared to the U.S. institution. In fact, in order for a staggered board to be effective as a defensive measure, directors should not be removed in the middle of their terms without justifiable cause – this is referred to as an "effective staggered board." Delaware corporate law offers a good, but very rare, example.[33] In Delaware, a successful bidder cannot remove the members of a classified board since such directors can be removed only for cause, under which transfer of control is not included. Interestingly enough, however, similar provisions are very rarely observed

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30 L. BEBCHUK/J. COATES IV/G. SUBRAMANIAN, The Powerful Antitakeover Force of Staggered Board: Theory, Evidence, and Policy, Stanford Law Review 54 (2002) 914–924.

31 Art. 385 para. 1 KCC.

32 *Id.*

33 § 141(d), (k)(1) Delaware General Corporation Law ("Any director […] may be removed with or without cause […] except as follows: (1) Unless the certificate of incorporation otherwise provides, in the case of a corporation whose board is classified […] stockholders may effect such removal only for cause.").

around the world, and thus the "effective" staggered board remains a quite unique U.S. institution. The KCC also lacks such a rule, and thus a staggered board does not work under the KCC.

c) Dual-Class Shares & Golden Shares

Dual-class shares or multiple-vote shares – including golden shares as an extreme case – enable a controlling shareholder to be perfectly insulated from takeover threats. Since it is obvious that they completely paralyze the market for corporate control, commentators have long debated their social desirability. It is often argued that a one-share-one-vote system is in most cases more socially desirable than dual-class shares system because controlling shareholders with multiple-vote shares have incentives to pursue private benefits excessively, especially when investor protection is not strong enough to deter them.[34] In spite of such a risk of increasing the agency costs of controlling shareholders, dual-class shares have been widely allowed in European countries, and in fact these shares were traditionally very popular in family-controlled listed companies in Europe.[35] Recently, however, it has been reported that the dual-class structure is less and less popular even in European listed companies,[36] and such decline was likely associated with the recent emphasis on better corporate governance practices. Several international soft laws on corporate governance, such as OECD principles or ISS Guidelines, favor the one-share-one-vote principle.

The KCC explicitly adopts the one-share-one-vote rule,[37] and thus the creation of shares with multiple or fractional votes is strictly prohibited. Non-listed companies are also subject to the same rule. The courts held that such a one-share-one-vote provision is a mandatory rule, and thus even the articles of incorporation cannot provide otherwise. In fact, the governmental committee for amending the KCC, which was launched in the period from 2005 to 2006 by the Ministry of Justice, has seriously discussed allowing dual-class shares, but the committee finally abandoned the proposal out of concerns over aggravating the agency problem associated with controlling families. Only non-voting shares – they might be common or preferred shares – and shares having a vote restricted to a certain agenda are allowed under the KCC.[38] In reality, however, these newly-added shares have not been popular in the Korean stock market.

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[34] R. J. GILSON, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harvard Law Review 119 (2006) 1652–1657.

[35] ISS EUROPE/ECGI/SHERMAN & STERLING LLP, Report on the Proportionality Principle in the European Union, 18 May 2007; SHERMAN & STERLING LLP, Proportionality Between Ownership and Control in EU Listed Companies: Comparative Legal Study, 18 May 2007.

[36] SHERMAN & STERLING LLP, *supra* note 35, at 12.

[37] Art. 369 para. 1 KCC.

d) Golden Parachutes

When incumbent directors are finally ousted by an unfriendly bidder, a golden parachute agreement often grants them a huge lump-sum severance payment or significant financial benefits. To be sure, the purpose of this agreement is to discourage a hostile bidder by placing a heavy financial burden on a bidder who successfully acquires the target. A golden parachute is merely a pay contract between executives and a company under U.S. corporate law, but under the KCC, it is normally included in the articles of incorporation, since the compensation of directors requires either approval by shareholders or specification in the articles of incorporation.[39] A mere compensation contract is not enforceable against the company.[40]

Is a golden parachute effective as a defensive measure under the KCC? A problem in this regard is that it is the legal policy of the KCC to prevent directors from making excessive payment to themselves, and such a legal policy is likely to be applicable to the hostile takeover context. One of the plausible responses of the managerial side is that a golden parachute is not compensation which is regulated by the KCC. This contract becomes effective only in the event of a change in corporate control, and thus it might be argued that such a severance payment is more likely a manner of liquidated damages when directors are removed before expiration of their terms.[41] Nevertheless, compensation is very broadly defined in this provision, and it includes not only ordinary salaries but also any other forms of remuneration given to the directors in return for their performance. A golden parachute is not an exception. Moreover, it is highly likely that a golden parachute agreement is in breach of the fiduciary duty of directors. Recently, for instance, the courts held that, even if it was approved by shareholder meeting, an excessive payment package for retiring senior managers would be in violation of their fiduciary duty and thus invalid under the KCC.[42] Overall, therefore, the availability of a golden parachute as a defensive tactic is quite limited in theory and reality.

3. Post-Bid Measures: Increasing a Defender's Shareholding

a) Issuance of New Shares or Convertible Securities to a Third Party

After a takeover bid is launched, the target managers are likely to make an effort to find a white knight and issue new shares to this third party. Since share issuance is likely to dilute the claim of existing shareholder, however, corporate law provides several schemes of investor protection. In the hostile takeover and

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38 Art. 344-3 para. 1 KCC.
39 Art. 388 KCC.
40 Korean Supreme Court 2004 Da 49570, 23 November 2006.
41 Art. 385 para. 1 KCC.
42 Korean Supreme Court 2014 Da 11888, 28 January 2016.

defensive measure context, it should be noted first that the KCC protects shareholder rights primarily with preemptive rights, whose basic structure comes from German corporate law. Unless otherwise provided in the articles of incorporation, each shareholder has a right to subscribe to new shares in proportion to his or her shareholding.[43] The KCC recognizes the same problem when convertible securities – such as convertible bonds and bonds with a warrant which can be converted to common shares – are issued, and thus shareholders are entitled to the same preemptive rights[44] in such cases. Pursuant to such regulation, a company which issues new shares or convertible securities to a third party should meet several requirements, among which is the question of whether the company has a proper "business purpose", a topic that has been frequently disputed in courts.[45] This provision was introduced to the KCC in July 2001 and has also been applicable to the hostile takeover context. In order to use it as a defensive scheme, therefore, the purpose of the incumbent board – arguably defending themselves against hostile takeovers – should be construed as a proper business purpose of the company.

The courts seem to assume that the purpose of defending control is associated with the personal interest of current management, not with interest of the company itself. It was held, for instance, that, when a battle for corporate control is anticipated, the issuance of convertible bonds should be nullified if the purpose is solely to impede a change of control.[46] Several trial court decisions applied such approach to the issuance of new shares,[47] and the Supreme Court finally held that the purpose of defending against hostile takeovers does not fall into the "business purpose" required by the KCC.[48] However, this conclusion was not derived from policy discussions on hostile takeovers, and in fact it was simply another example of a narrow interpretation of the statute. The court does not take into account whether it is necessary or socially desirable for the company to initiate a defensive measure, such as issuing new securities to a third party. Instead, it held that "the KCC aims to protect shareholders' preemptive rights by allowing a third party issuance only for the limited use that is necessary for a company's business."[49] The notion of a "business purpose," so the argument went, should be defined narrowly. The

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[43] Art. 418 para. 1 KCC.

[44] Art. 513 para. 3 KCC; Art. 516-2 para. 4 KCC.

[45] Art. 418 para. 2 KCC; Art. 513 para. 3 KCC; Art. 516-2 para. 4 KCC ("A company may issue shares to persons other than shareholders in accordance with the articles of incorporation; provided, however, that such issuance shall be limited to situations where it is necessary to achieve the business purposes of the company, including development of new technologies and enhancement of financial structure.").

[46] Korean Supreme Court 2000 Da 37326, 25 June 2004.

[47] Seoul Central District Court 2005 Kahap 744, 13 May 2005.

[48] Korean Supreme Court 2008 Da 50776, 30 January 2009.

[49] *Id.*

court, however, seemingly failed to suggest any convincing reasons for weighing the preemptive rights against other considerations.

Such a narrow and formalistic interpretation appeared once again – in the opposite direction – in the public offering context. Conceptually, a public offering of new shares also infringes upon the preemptive rights of existing shareholders, but the Korean Capital Market Law (hereinafter "KCML") explicitly provides that the business purpose requirement is not applicable to a public offering.[50] The legislative intent was not obvious, but the impact of deleting such a requirement was huge in relation to hostile takeovers. It tempts, for instance, a conclusion that the issuance of new shares through a public offering can be allowed even if the purpose is to defend control, since the KCML does not require a proper business purpose. Whatever the intention or purpose of the company may be, the company can engage in a public offering. In fact, this is what a trial court held in 2009.[51] In general, however, a public offering has not been preferred as a defensive measure since it is not only the hostile bidder but also the defending party that is influenced by its dilution effect.

b) Sale of Treasury Shares to a Third Party

The doctrinal problem on the sale of treasury shares is still unresolved in Korean corporate law. It has been theoretically well-established that the economic conception of treasury shares is just a cancellation of shares.[52] Thus, a stock buyback is equivalent to a return of the investment to shareholders, and the resale of treasury shares has the same effect as the issuance of new shares. However, such an economic conception was only partially considered under the KCC. The amendment of the KCC in 2011 modified the rules on a stock buyback so as to treat it as dividends if the buyback is carried out on pro-rata basis,[53] but it failed to incorporate such an understanding with respect to the sale of treasury shares. While issuance of new shares to a third party requires a proper business purpose,[54] this rule is not applicable to the sale of treasury shares. No provisions in the KCC explicitly require a company to prove a business purpose, and the courts also hesitate to create judge-made requirements to do this. Several trial courts have held that the sale of treasury shares

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[50] Art. 165-6 para. 4 KCML ("The Article 418 Section 1 and Section 2 Proviso of the KCC are not applicable").

[51] Seoul Central District Court 2009 Kahap 2887, 19 August 2009.

[52] R. A. BREALEY/S. C. MYERS/F. ALLEN, Principles of Corporate Finance (8th ed., New York 2006) 420; S. A. ROSS/R. W. WESTERFIELD/J. JAFFE, Corporate Finance (9th ed., Boston 2010) 583–585.

[53] Art. 341 para. 1 KCC.

[54] Art. 418 para. 2 KCC.

does not trigger shareholders' preemptive rights.[55] Thus, a company may utilize treasury shares as a defensive measure by transferring them to a white knight, which was not allowed when it comes to the issuance of new shares.[56]

The sale of treasury shares was used once again and legally disputed in the recent high-profile merger within the Samsung Group, between Cheil Textile (hereinafter: "Cheil") and Samsung C&T (hereinafter: "C&T") in 2015. Cheil and C&T of Samsung Group were controlled by the same family, but there was a huge gap in the size of direct ownership held by the family: 42% for Cheil and 1.7% for C&T. In the attempted merger between these two companies, it was allegedly claimed that a merger ratio was substantively unfair so that the merger would end up transferring wealth from C&T shareholders to Cheil shareholders. Thus, the key question was whether or not the merger proposal would be approved in the C&T shareholders meeting, a proposition that in fact remained uncertain. As of the end of 2014, the controlling shareholder controlled merely 16.9% of C&T – with 1.7% directly owned by the controlling family and the remaining 15.2% owned by the group-affiliated companies. Institutional shareholders owned 28.5%, including 13.1% owned by the National Pension Fund. Even though all the institutional shareholders intended to join the controlling family of Samsung Group, the expected total would have been only 45.4%, which was likely to fall short of two-thirds of the votes present at the shareholder meeting, which was necessary to pass the merger proposal. C&T then made a decision to transfer the treasury shares, 5.8% of the total issued shares, to the KCC Corporation, allegedly a white knight that would help the controlling family. Needless to say, the KCC Corporation voted for the merger proposal.

Contrary to conventional wisdom, the sale of treasury shares has very little impact on the final voting outcome when a defending party has already secured a significant size of votes.[57] This proved to be the case also in the Samsung Group merger. A sale of 5.8% of shares to a friendly buyer did not increase the voting power by the same amount. The merger was actually approved by 69.53% of attending shares – 83.57% of total outstanding shares attended and 58.91% voted for the proposal – in the shareholder meeting. But even if C&T had not sold the treasury shares, the merger proposal would have

[55] Suwon District Court Sungnam Branch 2007 Kahap 30, 30 January 2007; Seoul North District Court 2007 Kahap 1082, 25 October 2007; Seoul Central District Court 2015 Kahap 80579, 7 July 2015.

[56] When it comes to a defensive share repurchase, U.S. commentators tend to pay attention to the "buyback" stage. *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (Del. 1985) also dealt with a self-tender of the target company. In Korea, by contrast, a defensive share repurchase generally means the "sale" of treasury shares to a third party.

[57] Since the economic effect in this context is very similar to that of the issuance of new shares, the effect of having little impact on the final voting outcome is also observed in the issuance of new shares to a third party.

been approved with the consent of 68.29% of attending shares – with 77.77% in attendance and 53.11% voting for the proposal. The sale of 5.8% treasury shares brought merely a 1.24% difference in the final voting outcome. *Ex-ante,* however, the Samsung Group could not help taking all possible measures to secure shareholder approval.

The validity of C&T's sale of the treasury shares to the KCC Corporation was contested at court. The plaintiff argued that C&T could not prove a proper business purpose, and thus the sale infringed the preemptive rights of C&T shareholders. Nevertheless, the court again repeated its holding that the rules on issuance of shares are not applicable to the sale of treasury shares.[58] Surprisingly enough, one of the main arguments of the courts was that these two transactions are in fact economically different. According to their understanding, while the issuance of new shares increases the amount of a company's legal capital and is likely to change the equity ratio of existing shareholders, the sale of the treasury shares does not have such an effect. Such an understanding is, however, flawed as the courts compared apples and oranges. What the court should have compared to the sale of the treasury shares was not the simple issuance of new shares but the issuance of new shares coupled with cancellation of existing treasury shares. Such a comparison would reveal that the economic nature of both transactions is indistinguishable.

It would not be my argument that the economic substance should always prevail over the form. To be sure, the law often respects the form and thus gives the parties several legal options for obtaining the same economic outcome. Being economically identical does not necessarily mean that they should be treated in the same manner. Rather, I would argue that the court appears to have jumped to a conclusion based on an incorrect understanding of the economic nature of treasury shares.

4. Post-Bid Measures: Decreasing the Acquirer's Shareholding

One of the commonly used defensive measures is to reduce the size of voting rights of a hostile bidder. The management or a controlling shareholder of the target tends to prefer the relatively easy way out – increasing its own shareholding. If, however, this is no longer feasible, the party or parties will often seek a measure to reduce or eliminate the voting power originally possessed by a bidder. The U.S. style poison pill, for instance, is one of the most popular defensive measures among Delaware companies. In Korea, however, it has rarely been observed. Greenmail – in a modified format – and the Pac-Man defense are not legally prohibited, but they require a huge amount of money, enough to buy out the shares of a hostile bidder. A U.S.- or Japanese-style poison pill is

[58] Seoul Central District Court 2015 Kahap 80579, 7 July 2015.

not allowed since a stock option cannot be issued independently of issuing bonds, with the exception of a managerial compensation scheme.

a) Greenmail

Although not as popular as in the 1980s, a Delaware company may buy back its own shares from a hostile bidder at a significant premium. The target management is willing to pay such a premium since it benefits the management whereas the cost falls on the company. The KCC, however, prohibits such stock buyback. A company can repurchase its own shares as long as it is equivalent to paying dividends. Thus, the company engaging in such a buyback should prove that (1) the payment comes from the company's distributable earnings and (2) all the shareholders are equally given opportunities to sell their shares or the transaction was carried out in the open market.[59] When a company negotiates a purchase of its own shares with only a specific shareholder, it does not meet either requirement. Traditional greenmail is not available.

In a concentrated ownership system, however, a controlling shareholder – and not the target company itself – often negotiates with a hostile bidder to acquire shares. This is simply a private purchase and thus is not subject to the stock buyback regulation under the KCC. To be sure, however, such a modified version is not preferred, either. A controlling shareholder needs to raise capital to buy the shares from a greenmailer, and it is his or her out-of-pocket cost.

b) Pac-Man Defense

Another unpopular defensive measure is the Pac-Man strategy, in which the target company acquires a significant amount of shares of the acquiring company and thus threatens its control. In fact, the KCC has a very unique rule, under which a significantly cross-held company is deprived of its voting rights. If, for instance, Company X owns more than 10% of Company Y, the shares in Company X that Company Y owns will not correspond to exercisable voting rights at Company X's shareholder meeting.[60] The target company may strategically make use of this rule. In other words, if the target succeeds in owning more than 10% of a bidder, it eliminates the voting power of the target shares that a bidder owns, however large they are.

This appears a very clever and novel idea, but it has been very rarely attempted even under the KCC. The problem with this measure is that a target company has to raise huge capital to buy more than 10% of a hostile bidder. To be sure, such a problem is particularly exacerbated when a bidder is relatively larger than the target, which is often the case. Although legally al-

[59] Art. 341 para. 1 KCC.
[60] Art. 369 para. 3 KCC.

lowed, the greenmail and Pac-Man defenses have almost never attracted attention from scholars and practitioners.

c) *Poison Pill*

A poison pill is a call option that allows the target shareholders to acquire new shares when the triggering event occurs. The nice feature is that the holder of a poison pill cannot exercise the option before it is triggered, and thus this device does not incur unnecessary costs. Moreover, in order to use a U.S.-style poison pill, a company does not have to issue it in advance before a tender offer is launched. Similarly, an amendment of the articles of incorporation is unnecessary for adopting a pill. Thus, such a "shadow pill" under the Delaware law actually precludes a bidder from attempting to acquire a target company even if a company does not adopt any takeover defenses. It is well recognized that the invention of the poison pill three decades ago totally changed the landscape of hostile takeovers.

This would not be the case in Korea, however. Under the KCC, it is impossible to issue a poison pill simply because a company cannot issue a warrant independently. The warrant – a call option to buy the issuer's shares – is included in the "securities" which cannot be publicly issued without a specific enabling provision in the KCC or in other relevant laws. In other words, a company cannot "create" a security, even if the issuer and all the investors agree as to its contents. This is another example of a very narrow interpretation of the statutory clause at issue. While it is true that issuance of a warrant is explicitly permitted by the KCC only in association with a certain bond – a bond with a warrant – or in the form of stock option compensation paid to top management or employees, the KCC does not mention anything about whether a warrant can be issued in situations other than those cases. Yet commentators and legal practitioners regard this approach of the KCC as a prohibition.

The Korean government attempted to introduce a poison pill in 2010. The Ministry of Justice organized a committee in 2008 to examine the social benefits and costs associated with a poison pill and to prepare an amendment proposal for the KCC. The proposal recognized that companies inefficiently engaged in stock buybacks as a defensive tactic, and thus it was urgently necessary to provide for more defensive measures to achieve equal footing against a bidder. According to the governmental proposal, a company should be required to amend the articles of incorporation in order to issue a warrant for a defensive purpose. The basic structure of the Korean poison pill looked to the U.S. counterpart, but it had several distinguishable features. Most importantly, the proposal explicitly required a company to prove that the issuance of a poison pill – defending against a hostile bidder – would increase either the firm's value or shareholder value. As always, it was not clear how this could be done by a company.

The proposal was not successful, however. Scholars were very strongly opposed it since they believed that additional measures allowing controlling shareholders to defend themselves end up merely exacerbating, and not mitigating, the agency problems associated with controlling families. It was argued that a poison pill would very likely paralyse the corporate control market in Korea. Commentators did not clearly state, however, whether they opposed only the poison pill or defensive measures in general. In fact, it was not fully recognized that the power of a poison pill can vary depending on the design of the plan, and thus the details – issuance, exercise, and redemption – were not fully discussed. It appeared, therefore, that commentators have a strong antipathy to defensive measures in general.

It would be worthwhile to note that the above discussion was limited to enabling the warrant only for defensive purposes. The issuance of a warrant in general was not discussed in the period from 2008 to 2010.

IV. Concluding Remarks

It is well known that the attitude toward defensive measures is quite different between the U.S. and European countries. As examined above, U.S.-style defensive tactics are not available under Korean corporate law, and thus, on the surface, Korea appears to adopt the European approach. A poison pill cannot be implemented, a staggered board is not effective, dual-class shares are unlawful, and the issuance of new shares to a friendly third party is not available for defensive purposes. It should not be ignored, however, that this passive attitude was not based on policy discussions. Rather, it resulted from inflexible and narrow statutory interpretations, a topic which should be re-examined in the future.

Given that there are very few defensive measures available under the KCC, the resulting and legitimate question is whether this situation should be revised. Is there a need to allow more takeover defenses in the Korean securities market? *Maybe not.* In many corporate groups, controlling shareholders substantially exercise more than 50% of the votes utilizing the shares owned by affiliated companies. To be sure, there are several companies, even in corporate groups, in which control by the controlling families is vulnerable. Yet even in such companies, this paper has argued that there would be few, if any, social benefits additionally obtained from allowing more defensive measures. The real problem in the current Korean business sector is the lack of a takeover threat, and thus it is not an efficient legal policy to allow more takeover defenses.

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