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A Critical Analysis of China's Listed Companies' Defensive Capability against Hostile Bids

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Abstract. Takeover activities in China have experienced rapid development because of the reform of the financial market. Though the authority has achieved considerable progress in attempting to establish a coherent and predictable regulatory regime for takeover activities in the last three decades, the current framework is extremely complicated and fragmented. After analyzing the nature of the non-frustration rule from the available defenses in theory and practice, and considering the defensive capability of listed companies under China's company law without the non-frustration rule, it is obvious that there are many problems arising from the weak defensive capability of China's listed companies. For example, fund management benchmarking transmits outside short-termism into the board and the bargaining power of the management to negotiate a better price for its shareholders is impeded. Especially when the asset acquisition involves intangible assets such as patented technologies and trademarks. The article submits that the non-frustration prohibition should be abolished to enhance the defensive power. Moreover, further interpretations about the demarcation of the corporate power between shareholders and directors should be contemplated to clarify the range of directors' discretions concerning defensive measures.

Keywords. financial market; takeover activities; hostile bids; non-frustration rule; defensive capability

1、 Introduction

China has experienced a rapid growth of the external investment in recent years, especially after joining the WTO. Though the takeover activity is still relatively low in China's capital market compared to that of the US and the UK, the number and the transaction amount of takeover activities surged from 2005-2023.[1] As an emerging market, there are many unique features of its listed companies, the ownership structure and the state market. However, China's company law is still not detailed of defensive capability against hostile bids and the China Securities Regulatory Commission mainly focuses on regulating the behavior of the purchaser. The relevant regulations are too dispersed and have not yet formed a rigorous regime. Thus, domestic companies encounter many problems from the weak defensive capability.

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2、 The Defensive Capability of China's Companies

A. China's financial market

After the establishment of the country, the authority implemented the planned economy before the Chinese economic reform in 1978. The distinct feature of the prior economic system is to highlight the dominant position of the administrative power in determining the allocation of resources, rather than the market. Under such an institution, there was no room for the development of takeover activities. The aim of the reform in 1978 was to combine principles of the market economy with features of China's socialist economy. A series of supplemental policies have fundamentally changed the way that the government and the market behave. The first case regarding takeover battle was between Yanzhong Shiye (the target company) and Shenzhen Baoan Group (the bidder) in 1993. Other impetuses also promote the prosperity of takeover activities in China.[2] For example, China acceded to the World Trade Organisation (WTO) in 2001 and further opened the domestic market to foreign investors. Though many significant takeover activities are not China-driven transactions, it is crucial as part of the deal for the Chinese listed companies to be taken over. This part will provide an overview of China's financial market from listed companies, the ownership structure and the state market.

(a) Listed companies

The number of listed companies has experienced a rapid growth in the last three decades. The authority has adopted some special measures to push forward this process. Two stock exchanges, namely Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE), set up in 1990 in mainland, thus China have created a new era for the increase of listed companies.[3] It is worthy to note that both of the two stock exchanges are closely monitored by China Securities Regulatory Commission (CSRC), which is the watchdog of the Chinese capital market. Meanwhile, it required unincorporated enterprises to adopt the modern company structure. By the end of 2023, the number of China's listed companies in SZSE and SSE ranked fifth and ninth in the world.[4]

(b) The ownership structure

The proportion of dispersed shareholders in China's listed companies has raised significantly as a result of the non-tradable shares reform in 2005. In the past, the concentrated ownership structure was one of the manifest characteristics of China's stock market, which is quite different from the 'Anglo-American' system. The evidence has shown that even medium-sized companies in the United States (US) and the United Kingdom (UK) 'remain mostly widely held'.[5] By contrast, about two-thirds of shares of listed companies were held by the state and state-controlled enterprises before the reform in China.[6] Such shares held by the state and state-controlled enterprises consist of non-negotiable shares, which are prohibited from selling in the stock exchange.[1] The non-tradable shares reform was launched by CSRC in 2005 to solve such a situation.[7] The authority also regarded takeover activities as an essential driver for the process

[1] SSE and SZSE have two categories of shares, namely A-shares and B-shares. A-shares are denominated in Renminbi and only available for domestic investors, while B-shares are denominated in foreign currency and only open to foreigners. The barrier between the two markets is gradually decreasing. The authority permitted domestic investors to purchase B-shares in 2001 and allowed the qualified foreign institutions to buy A-shares in 2003. A-shares are further divided into negotiable shares and non-negotiable shares. Negotiable shares can be traded in the marketplace and are mainly held by public investors. Non-tradable shares are owned by the state and legal entities which are prohibited from selling in the stock exchange.

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of the privatisation of the state-owned companies. The reform has been enforced for nearly twenty years, and dispersed shares have increased significantly as a result of the decrease of the non-tradable shares. The percentage of state-owned shares shrunk sharply from 47.838% in 2004 to 1.1% in 2023.[8] Therefore, it is a meaningful step forward because the prospects for the takeover activity would be brightened with the increase of dispersed shareholders. This article only discusses the A-shares in mainland China.

(c) The state market

Though the takeover activity is still relatively low in China's capital market compared to that of the US and the UK, the number and the transaction amount of takeover activities surged from 2005-2023. As an emerging market, there are three unique features of its capital market. Firstly, negotiated takeover is the most common method to take over another listed company, rather than the contractual offer. It accounts for 60.77% among all the transactions from 2019-2023. And share deals are more popular than asset deals. Secondly, the socialist nature of the Chinese market economy decides that takeover activities should be confined to the approved list set by the administrative regulators. The extent of administrative approval and supervision in China is higher than other mature capital markets. Although the vice chairman of CSRC said that 90% of these activities could be accomplished without the approval of CSRC except certain aspects, the ministry approval is still necessary if the takeover of listed companies is related to the national industrial policy, industry access and the transfer of state-owned shares. Thirdly, the phenomenon of the market for corporate control as a solution to address managerial agency problem in the highly developed capital market has not completely emerged in China. This is a result of low hostile activity and absence of other relevant mechanisms. Despite the effort from the authority to alter the concentrated ownership structure in China, this reform is not robust and inadequate to date.

(d) Hostile bids

Until now, China's emerging market has experienced very little hostile takeover activity, and almost all of the target companies in takeover cases had few non-transferable shares.[9] Hostile takeovers are rare around the world because they can only happen in countries with widely dispersed shareholders, for which they are also scarce.[10] After the China's first takeover battle in 1993, there were only forty similar cases by the end of 2023. The fundamental reason is that the ownership of listed companies is not adequately dispersed to allow the transfer of corporate control except on a negotiated basis. Before the non-tradable shares reform, it is unlikely that a bidder could succeed without the cooperation of the small number of controlling shareholders of the company.[11] Once the ownership of listed companies becomes diffused, the hostile takeover is likely to appear at some point. Therefore, unsolicited bids for publicly listed companies in China will experience further development in the near future. Though there are still some special regulations on foreign investors, the Chinese takeover market has become the centre of the global market. China has experienced a rapid growth of the external investment in recent years, especially after joining the WTO. A series of policies aimed at promoting foreign investment also have encouraged the prosperous expansion of cross-border takeover activities. Meanwhile, the authority has permitted foreign investors to purchase A-shares in 2002. The most severe dilemma domestic companies encounter pertains to the extent of the openness of Chinese market subjected to the takeover by non-native companies. There have been a few cases that foreign companies have successfully obtained control of Chinese national brands. For example, Anheuser-Busch paid $717 to win the takeover battle against Harbin Brewery in 2004.

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The latter is the first brewery in China, which was built in 1900. Although the Ministry of Commerce has promulgated the Provisions on Acquisitions of Domestic Enterprises by Foreign Investors to place limits on the foreign takeover in specified areas, cross-border takeovers are expected to continually rise with the reform of China's capital market.

B. China's non-frustration rule

(a) The legislative evolution

To fully comprehend the legal panorama governing takeover activities, it is crucial to understand the Measures for Regulating Takeovers of Listed Company (the Takeover Regulation) issued by CSRC in 2002. Before the promulgation of the Takeover Regulation, the legal regime had been silent on the legitimacy of takeover defences for a long time. The Takeover Regulation was amended in 2006 to suit the changed circumstance after the non-tradable shares reform in 2005. It was last revised in 2020, which has notably contributed to the integrity of China's takeover regulations. The constant revisions were responsive to the changing environment and strategic restructuring of the national economy. The first version of China's non-frustration rule was stipulated in the 2002 Takeover Regulation and was altered thereafter in 2006. The previous article required that apart from performing the existing contracts or the previous decisions made by the general meeting, the target board shall not propose the following measures: '(1) issue new shares; (2) issue convertible company bonds; (3) repurchase the shares issued by the company; (4) modify the article of association; (5) conclude contracts that may have significant influence on the assets, debts, equities, or business performance of the company, except for the purpose of conducting the ordinary business; (6) dispose of or purchase material assets, adjust the principal business of the company, except when the firm encounters severely financial problem.' The two parts of the article are conflicting because the first part stated the principle of defensive actions taken by the board, but the second part set forth that the listed actions were always prohibited no matter whether they satisfy the principle or not. Since the authority was also aware of the problem later, this article was changed in 2006.

(b) Available defences in theory

China's non-frustration rule prevents the target board from engaging in frustrating action once the bid is announced. The primary function of the prohibition is to limit the ability of the target board to resist a hostile bid for entrenching its interests. Although a special committee was established by CSRC to provide consultative opinions, it is not a self-regulatory body as the final decision right is still controlled by CSRC. The committee is comprised of professionals and tackles issues related to takeovers. For instance, whether a takeover of a listed company is constituted or if the listed company is eligible for takeover.

To fully comprehend the legal panorama governing takeover activities, it is crucial to understand the Takeover Regulation issued by CSRC in 2020. The non-frustration rule can be found in Article 8 and Article 33 of the Takeover Regulation. The general prohibition in Article 8 provides that the board cannot abuse the delegated power to create obstacles to the bidder or misuse the company's assets to provide financial assistance to the preferred bidder. The defensive measures should be beneficial to the target company and its shareholders. The board has to maintain a neutral position towards all bidders and directors should comply with the duty of loyalty and the duty of care. More detailed guidance on the specific actions that the target board cannot engage in is stipulated in Article 33. It states that without the approval of the general meeting, the target board cannot 'produce significant effects on the assets, liabilities,

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equities, and business performances of the company.' The article lists a series of specific actions which may influence these aspects, including disposing of the company's assets, making external investments, adjusting main businesses, providing guarantee and loans. The enumerative actions are not exhaustive. The aim is to illustrate which target board actions can be defined as such that 'produce significant effects on' the above-mentioned aspects of the company. The restriction applies from when the bidder makes a 'suggestive announcement'.

These restraints do not affect carrying on normal business activities or enforcing resolutions of the general meeting. In theory, there is no restraint on the defensive action if it can be completed prior to the announcement of the bid. Ex-post defences which have significant effects on the above aspects of the company are only permitted with the approval of the general meeting.

(c) Actual effects in practice

Due to the ambiguity of the terms and the absence of authoritative interpretations, to ascertain the legitimacy of the specific defence is controversial under China's non-frustration rule. The complex questions can be best illustrated by two infamous cases regarding hostile takeovers, namely GF Securities (the target company) and Citic Securities (the bidder) in 2004, which reflected the specific content of 'significant influence' is hard to decide in practice. In this case, the target company established a new company which was owned by its directors and employees to frustrate the hostile bid. Meanwhile, the target company also had cross-shareholding system with two of its major shareholders. After negotiating with the two controlling shareholders, they decided to conduct negotiated acquisitions from other shareholders and the incumbent directors offered assistance to them. The result was that these three companies jointly possess 66.67% of the target company's shares through the above transactions.[12] Since it was unlikely for the bidder to succeed, it withdrew the offer. The problem is that the *ex-post* defence selected by the target board was not approved by other shareholders. Without the approval of the general meeting, the validity of the defence will depend on whether it has a vital impact on the 'assets, liabilities, equities and business performances' of the target company. However, there is no precise interpretation about whether the negotiated acquisition satisfies the prohibition or not.

The second case involved hostile takeover was between ST Meiya (the target company) and Vanward New Electric (the bidder) company in 2003. It revealed that the strict interpretation of the 'suggestive announcement' would substantively limit the expected effect of the rule. In this case, the target company was in a serious financial problem for more than two years.[13] The controlling shareholder of the company attempted to transfer 29% of its shares to the hostile bidder without notifying the target board. Incumbent directors of the target company strongly opposed this deal because they considered it was detrimental to the long-term profits of the company. The target board decided to pay pension to employees. The pension had been postponed for a long time due to the financial situation of the company. After that, the controlling shareholder gave up the original share transfer and concluded another agreement with a preferred company of the board. Though the board just won the support from minority shareholders, it will render the remaining shares insufficient for the bidder to complete the takeover. Another reason is that the controlling shareholder is the local administrative regulator. Thus, the objection from employees will be cautiously considered. To pay superannuation to employees is an *ex-post* defence which was likely to have a significant influence on the above aspects of the company. However, according to the strictly literal interpretation of the article, the prohibition does not apply to this case because there is no suggestive announcement made

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by the bidder. Compared to the UK's non-frustration rule, the Chinese version has no restriction on the board if it 'has reason to believe that a bona fide offer might be imminent'[2]. It only applies when the bidder has made a suggestive announcement towards the target company. From the above analysis, it is suggested that China's non-frustration rule is too general to ascertain whether a particular tactic is lawful or not.

C. Availability of defences

(a) Drivers of the debate

The heated discussion about the defensive capability of China's companies is mainly ignited by three issues. Firstly, the hostile takeover aimed at China's biggest real estate developer, Vanke, has attracted public attention. The saga lasted for two years and ended with the founder of the company resigning as chairman eventually. The second driver of the proper takeover defence debate is the difference regarding the defensive capability between public companies listed in mainland China and those listed abroad. The obvious distinction is that there are many cases in which overseas-listed companies have successfully implemented the poison pill to defend hostile takeovers. However, there is rarely similar case related to domestic-listed companies. For example, China's largest internet portal, Sina Corp, has successfully set forth a shareholder right plan to defend the hostile bid initiated by Shanda Group in 2005. Both companies were listed in Nasdaq, rather than mainland China. The third driver is about the future development of Chinese companies from the overall socio-economic perspective. It is similar to the UK that this aspect has not caused the debate about the non-frustration rule, but it does have the potential to draw public attention in the near future because of issues such as the dwindling productivity gains. It has been observed that China has propelled its economic progress by transferring underutilised labour and capital into a socialist market economy. The report presented by economists at Rabobank has pointed out that the current economic system in China against the 'favourable entrepreneurial environment and Schumpeterian creative destruction'. Another concern is relevant to the short-term preference reflected in the business strategies and the extent to which such pressure from the outside market can be transmitted into the board. This problem is gradually emerging after the non-tradable shares reform. Although statistic indicates that China is the second research and development (R&D) performer in absolute terms around the world, another analysis reveals that the innovative ability of industrial enterprises is still depressed. In some areas, there are still problems such as insufficient integration of the innovation chain with the industrial chain, inefficient allocation of resources, and unsound mechanisms for cooperation among industries, universities and research institutes. The long-term development of China's economy cannot only depend on the comparative advantage of labour resources. The authority has realised this issue and promulgated policies to encourage R&D investment. However, due to the existence of transmission mechanisms, the short-term pressure from the capital market still impacts the business strategy of listed companies.

(b) Stipulations in Company Law

China's company law emphasises the primary role of the general meeting in deciding vital corporate strategies. It stipulates that the general meeting is 'the authority of the

[2] The Takeover Code of United Kingdom, Rule 21.1

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company'[3], and the board should 'report to the general meeting'[4]. Consequently, company law entitles a broad range of corporate powers to the general meeting, including other rights specified by the article of association. There are three special issues that require the approval of the shareholders representing 2/3 or more of the voting rights, including increasing or reducing the registered capital, deciding merger, split-up, dissolution, liquidation or other matters which will influence the form of the company, and altering the article of association.[5] By contrast, the board assumes the task to enforce resolutions made by the general meeting and to formulate plans for the general meeting.[6] Under such a shareholder primacy context, it is unlikely that the target board could randomly deploy defensive measures without the approval of shareholders.

(c) Shareholder rights plan

The most potent defence in the US is the shareholder rights plan, otherwise known as the poison pill. The pill is created by the target board without shareholder approval through issuing warrants to the existing shareholders by means of interim dividends. The rights of the warrants are set forth in a shareholder rights plan which is permitted by the board. The warrant attaches to and is transferred with the share when the trigger event happens. Usually, the trigger event is prescribed as a bidder crosses a specific ownership threshold without the permission of the target board. The effect of the pill is to dilute the ownership of the bidder by allowing holders of the warrants, excluding the bidder, to purchase shares in the target company (flip-in plan) or the bidder company after the subsequent merger (flip-over plan) at a significant discount.[14] In the US, such a defence can be created at any time without the approval of the general meeting.

The different treatment between the bidder and other shareholders about the warrant is theoretically allowed according to the company law. The regulation requires that the issue of shares should comply with the principle of fairness and impartiality, which refers to shares of the same class should have the same rights and benefits.[7] Though there is no exact clause about the nature of the warrants, such an action of the target board does not violate the principle of the equal treatment. The reason is that the bidder contravenes the precondition to buy the warrants as he/she crosses the threshold without obtaining the approval of the board. Therefore, there is no unequal treatment between the bidder and the other shareholders. However, listed companies mainly look for a 'white knight' to resist the hostile bid in practice. [15]

Under the context of China's company law, the practical effect of the poison pill is limited by the troublesome procedure regarding the issue of new shares. The issue of new shares and warrants must be approved by the general meeting and CSRC. The issue of shares by listed companies must be approved by the shareholders representing 2/3 or more of the voting rights.[8] Moreover, the approval of CSRC is also necessary if the listed company intends to issue shares to the general public, to accumulatively more than 200 people and other situations prescribed by the law.[9] Considering the issue of warrants, there is no explicit stipulation about it in Chinese legislation. Therefore, apart from the approval of the general meeting, the procedure related to the issue of new shares and warrants in China is more tedious than the US and the UK.

[3] Company Law 2024, art 58.
[4] Company Law 2024, art 67.
[5] Company Law 2024, art 116.
[6] Company Law 2024, art 67.
[7] Company Law 2024, art 143.
[8] Measures for the Administration of Registration of Securities Offering by Listed Companies 2023, art 20.
[9] Securities Law 2020, art 9.

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Even if the general meeting has determined to deploy the defensive action, China's company law still allows shareholders to control the utilisation of the poison pill from three aspects. The substance of the pill is to empower the board to approve a bid or to redeem the pill.[16] In the US, companies adopt the poison pill and 'with cause' removal rights give the board much more discretion to resist the hostile bid. While under the default setting of China's company law, it is unlikely to achieve the expected effect. Firstly, the general meeting can easily change the board by a simple majority without cause to approve the bid. The general meeting is entitled to elect and change directors who are not representatives of the employees and deciding the matters connected with their salaries and compensations.[10] In the matter of whether the cause is needed when the general meeting intends to remove a director, the legislative attitude converted from 'with cause' to 'without cause'. The 1993 company law originally prevented the general meeting from dismissing directors without cause.[11] The authority deleted the term of 'with cause' in 2005. In addition, the resolution to remove a director just requires a simple majority of the voting rights at a general meeting.[12] Secondly, the interim shareholder meeting can be convened by shareholders at any time if one of the six designated situations can be satisfied. It includes (3) shareholders separately or jointly hold 10% or more of the company's shares or (6) other situations specified in the constitution.[13] Thirdly, the term of the board can be specified by the article of association, but the maximum term is three years.[14] Therefore, the poison pill can only grant the target board less power to defend the hostile bids in the context of these mandatory regulations. Meanwhile, the above analysis equally applies to other shareholder-approved defensive measures.

The authority has promoted the move from the existing approval-based system to a registration system.[17] To weaken the administrative grip on the listing process and to shift more power to the market is the primary aim of the reform. The crucial value is that CSRC changed the nature of its reviews from approving for pricing and timing to compliance-related issues, thus leaves all those details to the market. Since China's stock market is just three decades old and some ancillary measures are not mature, there is still a long distance to test the effectiveness of such a fundamental transform.

(d) Restructuring defences

This type of restructuring defences usually relates to extraordinary dividend to shareholders or share repurchase combined with either issue block of shares to a friendly party or increase of the company's leverage.[18] From the above analysis, issue shares by listed companies need to obtain approval from shareholders. Moreover, share buy-back is strictly restrained by China's company law as it might be abused to impair stakeholders' interests. There are only six circumstances under which the company can repurchase its shares: '(1) to decrease the registered capital; (2) to merge with another company which holds its shares; (3) to award its employees; (4) to purchase shares of its shareholder because he/she objects to the decision on the merger or split-up made by the general meeting; (5) to convert convertible company bonds issued by the company; (6) to maintain its corporate value and shareholders' equity.' [15] The first two matters should be approved by the general meeting, and the company

[10] Company Law 2024, art 59.
[11] Company Law 1994, art 115.
[12] Company Law 2024, art 71.
[13] Company Law 2024, art 113.
[14] Company Law 2024, art 70.
[15] Company Law 2024, art 162.

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has to transfer or write off the repurchased shares during a specified period. Repurchasing shares of the company is forbidden in principle, excluding some exceptional situations. Finally, the requirements for distribution is more demanding under company law. After making up previous years' losses and withdrawal legal reserves, the company can distribute dividends to shareholders. Therefore, restructuring defences can be deployed by the target board to resist hostile bids, but only in a limited scope and the process is tedious.

(e) Business decisions

Such a defence refers to business decisions made by the target board which have defensive effects. For example, the target board could sell a principal business asset or department to eliminate the bidder's interest in the company, which is known as 'crown jewels'. The capability of the board to deploy asset sales as the defence is confined in a specified scope by the law. Firstly, company law sets special provisions on the listed company on this issue. If a listing company purchases or sells any material asset that exceeds 30% of the company's overall assets within a year, such actions should be permitted by the shareholders representing 2/3 of the voting rights of the shareholders who attend the general meeting.[16] When the director involved in the matter to be decided at the meeting of the board, he/she cannot vote on this decision, nor may he/she vote on behalf of any other director.[17] Secondly, further constraints can be found in Measures for the Administration of the Material Asset Restructurings of Listed Companies. It applies to transactions beyond daily businesses which lead to material alterations in the principal business, assets, or revenues of the target company. For example, when the total assets purchased or sold occupies 50% of the total ending assets specified in the audited consolidated financial statements for the last fiscal year, the decision subjects to the demanding disclosure standards requested by CSRC.[18] Therefore, there is only little room for the target board to hinder hostile bids by means of the asset sale.

(f) Article of association

Setting forth special provisions in the company constitution to prevent the bidder obtain control of the company can also have defensive effects. From the empirical evidence, most companies have stipulations with regard to the selection or dismissal of board members.[19] However, the legitimacy of such defences has not been settled yet. The battle between Dagang Oilfield (the target company) and Shanghai Ace (the bidder) illustrates this problem. The constitution requires that nominating new board members should obtain approval from the incumbent board. Moreover, it raises the requirement for shareholders to nominate board members in company law. The controversial issue is whether such a stipulation is invalid as it infringes shareholders' fundamental rights. As there is no explicit demarcation of the corporate power between shareholders and the board, to ascertain the legitimacy of such a defence is difficult.

3、Problems of Weak Defensive Capability

Short-termism: from the market to the boardroom

Ownership structure, takeover regulation and fund managers operate as mechanisms to transmitting financial markets' short-term horizon into the Chinese boardroom. As it is put

[16] Company Law 2024, art 135.
[17] Company Law 2024, art 139.
[18] Measures for the Administration of the Material Asset Restructurings of Listed Companies 2020, art 12.

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forward by Mark Roe, short-term preferences in the stock market need a transmission mechanism into the company to influence board decision making.[20] Chinese listed companies were not subject to the short-termism pressure before the non-tradable shares reform because the concentrated ownership structure and those state-owned companies focused more on long-term interests. After nearly twenty years of the reform, the present stock market is mainly dominated by small investors, heightening volatility and short-termism. There are two categories of the transmission mechanism, including the connection between board rewards and market incentives, and the likelihood for directors to keep their position if they do not adapt to the short-termism. This article mainly focuses on the latter one.

Firstly, a gradually dispersed ownership structure poses difficulties for the target board to defend against hostile bids. In the context of the concentrated ownership structure, the target board will not be severely subject to the market short-termism if it can obtain the support from controlling shareholders. China's ownership structure has gradually become dispersed after the non-tradable shares reform in 2005. Meanwhile, retail investors account for a considerable proportion now. The changed ownership structure makes it more difficult for the board to resist hostile bids because the decision right is grasped by these small investors. Therefore, due to the dispersed ownership structure, other factors especially takeover regulation involved the defensive capability of the board influence the extent to which the board can reject the market short-termism.

Secondly, since the panorama of takeover regulation in China reflects a pro-shareholder approach, the target board cannot effectively use corporate power to deflect the short-term preference. It is suggested that directors can hugely dismiss the short-term pressure from the market in the US even under a dispersed ownership structure as they can create defences against hostile bids without shareholder approval.[21] However, there is little room for the board to deploy takeover defences in China. Company law substantively restraint the application of delegated corporate power by the board. Shareholder approval is the necessary precondition when the actions taken by the board relating to significant issues of the company. Therefore, the board cannot successfully use takeover defences to dampen the short-term horizon from the stock market in China.

Thirdly, the fund management industry has emerged as the most prominent institutional investor in China. The first batch of six fund management companies was established in 1998, and the total number has increased to 145 until the end of 2023.[22] At the end of 2007, the total asset under management accounted for 25% of the total market cap of tradable shares listed on the SSE and SZSE.

Though the fund management has not appeared for a long time in China, it also subjects to relative performance incentives. Firstly, since most mutual funds in China are open-ended, fund managers have incentives to cater to short-term profits of investors to prevent large-scale redemption. Secondly, comparative performance among competitive fund managers drives them to sell shares to the bidder, even if they believe that it is for the long-term interests to hold the share. In a competitive market for fund management services, investors will compare a fund manager's performance with other fund managers before they make decisions. The situation is similar to the UK that managers are hired 'by reference to their recent performance relative to other similar managers, and are guided in this choice by consultants who construct data bases for this purpose'. [23] Thirdly, the remuneration of the fund manager also relies on the success of the fund management. All these factors encourage fund managers to prioritise relative performance data and maximise short-term interests of retail investors, rather than pursuing the

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long-term profits for shareholders. Therefore, fund management benchmarking also operates as a mechanism to transmit outside short-termism into the board.

Shareholder value and bargaining power

The insufficient defensive ability of the target board in China impedes the bargaining power of the management to negotiate a better price for its shareholders. Under the widely dispersed ownership structure, the decisive right is in the hands of shareholders, rather than the board, when the company encounters hostile bids. The role of the management is to represent shareholders to obtain a better deal. This function depends on what defences can be deployed by the board to heighten its position at the table.[24] It is likely that the board will have more time to find another bidder who prefers to offer a higher price to shareholders if it can control the process of the transaction.

Recent takeover activities have shown that the Chinese target board is not very powerful as expected when it confronts hostile takeovers, no matter the bidder is the domestic investor or the foreign investor. It is undeniable that the immature stock market is an important reason. Compared with the US and the UK, Chinese listed companies have only been engaged in takeover activities for a short period. With the propelling of the reform, China's current ownership structure has changed to a large extent. Before the non-tradable shares reform, the concentrated ownership structure impeded the growth of hostile bids. With the further openness of the state market and deepening of the share reform, it is predictable that Chinese listed companies will encounter more hostile takeovers than before. Although China's regulatory approach is more similar to UK's, features of the financial market and strong administrative preference render the adoption of takeover defences more onerous. Considering the fierce discussion about UK companies' defensive capability after Kraft's takeover of Cadbury, Chinese companies will be in a much worse situation under the present legislative framework. Therefore, the weak bargaining power of the target board will result in the insufficient protection of shareholder value.

4、The Recommendations for Reform

(a) The acceptance threshold and disenfranchising shareholders

The proposals put forward by Roger Carr about increasing the acceptance threshold and disenfranchising short-term shareholders are also not available to protect the target company from hostile takeovers in China. It has been analysed by David Kershaw that both of the two methods focus on the wrong target. The problem is not that fund managers are driven by the comparative performance, but that long-term funds and shareholders are 'incentivized to sell into a premium offer even if it does not reflect fundamental value.' [25] Therefore, before alternative reforms can be discussed, one should consider the practical environment of the Chinese capital market.

(b) Abolishing the non-frustration rule

There are two reasons to justify the abolishment of the non-frustration rule. Firstly, the practical application of the non-frustration rule is confusing because of the ambiguous of the terms and the lack of detailed interpretation. Though the Chinese version is similar to the UK's, the forbidden period and actions are provided differently from it. The two takeover battles analysed above reflected the confusing situation with respect to its application. Under the current system, defects of the non-frustration rule not only distort its expected functions but also make the system more complicated. Secondly, abolishing the non-frustration rule in China

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will not result in abusing delegated power by directors. The legal regime governing takeover activities in China gives more concerns to interests of shareholders, especially the matters regarding decisive aspects of the company. Managerial agency problem arises from the separation between the ownership and the management. The problem lies in ensuring that the managers are responsive to the shareholders' interests rather than entrenching their interests. One of the primary functions of corporate law is to control this conflict of interest. Since China's company law indicates a pro-shareholder regulatory approach, the deployment of most defensive measures needs approval by the majority shareholders. Moreover, even if the board can obtain shareholder approval, shareholders can still control the practical use of defences. Apart from the restraint of the general meeting, administrative approval also plays a crucial role in preventing the misuse of directors' powers. Therefore, there is little room for the board to take advantage of corporate power to entrench the individual interest.

(c) Demarcating the corporate power

The abolishment of the non-frustration rule will only slightly enhance the defensive capability of the board. Further interpretations regarding the demarcation of the corporate power between shareholders and directors should be set forth to clarify the range of directors' discretions. One of the primary reasons that leads to the confusing dilemma regarding defensive measures is the lack of demarcation of the corporate power. The current legal regime does not provide an explicit guidance for directors to efficiently create defences. China's legal system is significantly distinct from the common law system, under which *stare decisis* principle does not apply. Chinese court cannot refine the flaws of the law by making judgements. Firstly, the Supreme People's Court in China can issue more detailed guidance cases and judicial interpretations to instruct lower courts concerning application problems. Although the article lists five detailed types, the fiduciary duties are too general to ascertain the legitimacy of some defences sometimes. Secondly, more detailed stipulations about the content of shareholders' fundamental rights should also be considered by the authority. It will decrease the confusion about the legitimacy of defensive measures. Therefore, more explicit demarcation regarding the corporate power should be contemplated to reduce the confusion related to the adoption of takeover defences.

5、 Conclusion

Recent reforms in China have promoted the prosperity of its financial market, especially with regard to takeover activities. The authority has promulgated a series of regulations to balance the protection of shareholders and the contestability of takeover activities. This article has attempted to provide an analysis of the defensive capability of China's companies under the current legal regime. It is suggested that to ascertain the validity of a particular defence under the non-frustration rule is confusing because of the ambiguity of the terms and the absence of authoritative interpretation. Considering the available defences without the non-frustration rule, there is still little room for directors' discretions in the context of China's company law. Even if shareholder approval can be obtained, shareholders can still control the actual use of the defence. Consequently, there is no reasonable justification for the existence of the non-frustration rule. However, the weak defensive capability prevents the board from disregarding market short-termism and negotiating a better deal for shareholders. Therefore, the article opines that China's non-frustration rule should be abolished to enhance the defensive power. Meanwhile, further interpretations about the demarcation of the corporate

power should be put forward to solve the confusion regarding the directors' discretions in selecting defensive measures.

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