LIMITATIONS OF LEGAL TRANSPLANTATION: THE COMPARISON OF TENDER OFFER REGULATIONS BETWEEN CHINA AND WESTERN COUNTRIES

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Abstract

The current Chinese takeover law transplants practices in Western countries, including the U.S., the U.K., and the E.U., which adopt hostile takeover regulatory frameworks to protect legitimate rights of the participants in the acquisitions. However, Chinese takeover law failed to provide enough and clear guidance for participants in takeovers, causing uncertainty and anxiety in Chinese market. This article will reveal the limitations of the legal transplantation in Chinese takeover law by analyzing the tender offer rules.

I. INTRODUCTION

In order to set order for hostile takeovers and protect the lawful rights of the participants, the U.S., the U.K., and the E.U. have all adopted regulatory frameworks in the hostile takeover domain. All of these models have set rigorous procedural and substantial rules for public acquisitions, in respect of tender offer. The federal statutes in the U.S., such as the *Securities and Exchange Act of 1934*, mainly addressed the procedural and form requirements for tender offers. The U.K.'s *City Code on Takeovers and Mergers* (hereinafter the *City Code*) in 1968 adopted systematic regulations on tender offers. Based on the *City Code* as well as the preliminary drafts of the *Council Directive*, the European Council also established strict rules for the tender offer.

All technical rules for tender offers have one purpose in common – to protect the lawful rights of the shareholders. In China, where individual investors accounts for the majority of the stock market players, tender offer is especially important. China established its national stock exchange in 1993; in the same year, the State Council clarified tender offer as a major way of company acquisitions in *Interim Provisions on the Management of the Issuing and Trading of Stocks*.[1] Thereafter, the State Council and the China Securities Regulatory Commission successively promulgated the Chinese *Company Law*, *Securities Law* and *Measures for the Administration of the Takeover of Listed Companies* (hereinafter the *Takeover*

[1] Gupiao Faxing yu Jiaoyi Guanli Zanxing Tiaoli (股票发行与交易管理暂行条例) [Interim Provisions on the Management of the Issuing and Trading of Stocks] (promulgated by St. Council, Apr. 22, 1993, effective Apr. 22, 1993) art. 48(1) (Chinalawinfo).

Measure). After several amendments and revisions, China has developed a complicated regulatory scheme on tender offers.

Like the U.K. and most E.U. member states, China has a mandatory bid rule stipulating that acquirers whose already-owned shares exceed a certain percentage of a listed company's total equities must issue an overall tender offer to all other shareholders of the said listed company.[2] The U.K.'s mandatory bid rule will be triggered when the acquirer holds 30% or more voting rights,[3] which is the same as the majority of E.U. member states'.[4] The trigger point in China is 30% as well, which, however, may refer to both 30% of the issued shares and 30% of the total shares.[5] Consequences under these two scenarios are also different according to how the acquirer crossed the 30% line.[6]

Besides the overcomplicated mandatory bid rule, the sell-out right in Chinese tender offer is even more problematic. Sell-out right originally comes from the E.U., which was provided to minority shareholders in The *Directive 2004/25/Ec of The European Parliament And of The Council on Takeover Bids* (hereinafter the *European Directive*). If a bidder has obtained securities representing 90% of the capital carrying voting rights and 90% of the voting rights in the target company, the minority shareholders can require him to buy out all of their securities.[7] Drawing on the experience of E.U., the Chinese Securities Law stipulates that the shareholders can sell their shares to the acquirer whose takeover bid causes the target company losing its listing status.[8] In China, the equity distribution requirement for listed company is very strict[9]; small listed companies must have their public-offered shares more than 25% of its total shares, while companies with registered capital over 400 million must have more

2 Zhengquan Fa (证券法) [Securities Law of the People's Republic of China] (promulgated by Standing Comm. of Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999 (2014) art. 88 (Chinalawinfo) [hereinafter 2014 Securities Law].

3 The Panel on Takeovers and Mergers, the City Code on Takeovers and Mergers (12th ed. 2016), Part F1, Rule 9 [hereinafter the City Code on Takeovers and Mergers].

4 *See* infra note 21. In E.U., 10 of 27 member states have set their trigger of mandatory bid rule at 30%.

5 *See* 2014 Securities Law, *supra* note 2, art. 88. In Chinese law, 30% of the issued shares is different from the concept of 30% of the total shares. Meanwhile, there are three statutory ways of acquisition in Chinese takeovers, *see* discussion *infra* Part II.

6 For example, when a purchaser acquires 30% of the issued shares of a listed company through securities trading on a stock market, further acquisitions shall be in the form of a tender offer. When an investor plans to purchase more than 30% of the issued shares of a listed company by agreement, the part of shares that exceed the foresaid 30% must by means of tender offer. When an acquirer indirectly obtains more than 30% of the total shares of the listed company, the acquirer shall send a general tender offer to bid for all outstanding shares of the listed company, otherwise the acquirer shall reduce its shareholding of the listed company to 30% or less. About the complexity of the Chinese mandatory bid rule, *see* discussion infra Part III.

7 Council Directive 2004/25, Art. 16, 2004 O.J. (L142) 8 (EC).

8 *See* 2014 Securities Law, *supra* note 2, art. 88.

9 *Id*. art. 51(3).

than 10% public-offered shares.[10] The prevalent non-public shares in Chinese listed companies give rise to the fact that the sell-out right trigger is much lower than 90% in China.[11]

As deficient as the Chinese sell-out right is the derogations of mandatory bid rule in China, which includes application-based derogations and non-application-needed derogations. Under extreme circumstances, acquirers do not even have to apply to get derogations from the mandatory bid rule. In conditions where the acquirer do have to apply to the China Security Regulatory Commission[12] (hereinafter *CSRC*) for the derogation, relevant regulations are loose and vague.[13] Investors with ulterior motives can easily exploit the loopholes, and once an applicant obtained derogation from the mandatory bid rule, he could find a way to circumvent tender offer forever. This leaves abundant room for majority shareholders to outsmart and outmaneuver minority shareholders.[14]

In all, current Chinese tender offer regulation incorporates an intricate mandatory bid rule and a sell-out right triggered too low; in addition, regulations on derogations of the mandatory bid rule in China are riddled with ambiguous statutes as well as confusing interpretation. This article deeply examines the Chinese tender offer regulations, compares its substances with its counterpart in U.K. and E.U., and offers material suggestions for future improvement. Part II of this article briefly introduces three statutory ways of acquisition in Chinese law. Part III gives a thorough review of the mandatory bid rule in China. Part IV illustrates the deficiency of Chinese sell-out right. Part V carefully analyzes the derogations of tender offer in China. Part VI discusses the possible improvements of tender offer regulation in China and Part VII concludes.

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[10] For the purpose of convenience in this article, Chinese listed companies with registered capital less than 400 million are referred to as small listed companies while Chinese listed companies with registered capital more than 400 million are referred to as large listed companies. Moreover, it's worth noting that in Chinese Law, public-offered share refers to share held by public individuals rather than legal persons.

[11] *See* discussion infra Part IV.

[12] The China Security Regulatory Commission is the main regulator in Chinese Securities Market, who has the ultimate and exclusive right over takeover disputes as a technocrat, just like the SEC in the United States.

[13] Shangshi Gongsi Shougou Guanli Banfa (上市公司收购管理办法) [Measures for the Administration of the Takeover of Listed Companies] (promulgated by the China Sec. Reg. Comm'n, May 17, 2006, effective on Sept. 1, 2006, amended Oct. 23, 2014) art. 61 and art. 62, (Chinalawinfo) [hereinafter the 2014 Takeover Measure]. Although first promulgated in 2006, the 2006 Takeover Regulation has been amended in 2008, 2012, and 2014 respectively.

[14] *See* discussion infra Part V.

II. THE TECHNICAL RULES OF PUBLIC ACQUISITION

According to Chinese Securities Law, an investor may acquire a listed company through tender offer, negotiations or other lawful means.[15]

If an investor adopts the means of tender offer to purchase shares of a listed company on his will, he may choose to send out either a general tender offer for all outstanding shares of the company, or a partial tender offer for part of the company shares. Under both circumstances, the tender offer is issued towards all shareholders of the listed company.[16]

Tender offer provides shareholders with adequate protection and certainty. According to Chinese Law, the price of the shares in the tender offer shall not be lower than the highest price at which the purchaser obtains within 6 months before the tender offer was issued[17], and shareholders can choose either cash or equitable legal transferable securities at their will[18]. Generally speaking, the open term for the tender offer shall be no less than 30 days and no more than 60 days.[19] When the terms of tender offer expire, the purchaser has to purchase all the preliminarily accepted shares. In partial tender offers, if there are more accepted shares than needed, the purchaser shall purchase the shares according to the sellers' shareholding ratio.[20] These safeguarding provisions in Chinese law protect shareholders from coercive tender offers and ensure all shareholders are treated equally in takeovers.

As compared with tender offer, share purchases through negotiations or other lawful means are usually more private, and do not necessarily have to be disclosed to public shareholders until the transaction is completed, or, the completion of such can be anticipated. In this way, it is more efficient and less costly for the acquirers. Under *2014 Takeover Measure*, acquisition of a listed company through other lawful means refers to indirect takeovers. In indirect takeovers, the participant is entitled to obtain securities carrying 5% to 30% voting rights through investment relationship, agreement or any other arrangement even though he is not a shareholder of the company.[21] Acquisitions through negotiations or any other lawful means may not be relevant to minority shareholders.

In theory, acquisitions through tender offer are usually shareholder-friendly but harmful to the management, as the acquirers

15 *See* 2014 Securities Law, *supra* note 2, art. 85.
16 *Id.* Art. 88.
17 *See* the 2014 Takeover Measures, *supra* note 13, art. 35.
18 *Id*. Art. 27.
19 *Id*. Art. 37.
20 *Id*. Art. 43.
21 *Id.* Art. 56.

are supposed to bypass the management and hunt for control of the company directly . On the contrary, acquisitions through negotiations or other means are pro-management in nature and deprive public shareholders of the opportunity to exit with a share premium.[22] In stark contrast with Anglo-American jurisdictions, in which acquisitions through tender offer are the mainstream, acquisitions through negotiations or other means are much more common in China.

Regardless of the specific means of acquisition, when an acquirer or investor holds 30% of the issued shares of a listed company, further company shares must be acquired through tender offer[23]. China transplanted this mandatory bid rule from European countries to protect the lawful rights and interests of the minority shareholders.

A. The Mandatory Bid Rule in the U.K. and European Union.

In the U.K., the *City Code* clearly mandates that "any person, or together with persons acting in concert with him, acquires shares carrying 30% or more of the voting rights of a company whether by a series of transactions over a period of time or not", shall launch an overall tender offer for all the outstanding shares of the target company.[24] In European Union, the *European Directive* has similar clauses. When a natural or legal person holds securities of a listed company to a certain level, mandatory bid through tender offer "shall be addressed at the earliest opportunity to all the holders of those securities for all their holdings".[25] In the U.S., however, the Williams Act of United States has no such rule. It only requires all the shareholders to be treated equally in a fair manner, and acquirers shall purchase shares on a pro rata basis if the preliminary accepted shares exceed their estimation.[26]

In the U.K., once the acquirer obtained 30% of the voting rights of the company, the mandatory bid rule applies. The European Council allows every member state to determine the "percentage of voting rights which confers control" according to their own circumstances[27], thus the thresholds among member states varies from 25% to 66%[28].

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[22] Bratton, William W., and Joseph A. McCahery. "Introduction to Institutional Investor Activism: Hedge Funds and Private Equity, Economics and Regulation." (2015).

[23] *See* 2014 Securities Law, *supra* note 2, at Art.88. *See also supra* note 6 for a detailed explanation of the complexity of the current Chinese Law.

[24] *See* The City Code on Takeovers and Mergers, *supra* note 3, § F1, Rule 9.

[25] Council Directive 2004/25, Art. 5, 2004 O.J. (L142) 8 (EC).

[26] The 90th United States Congress, Williams Act (82 Stat. 455), Section 14d, Section 14e.

[27] Council Directive 2004/25, Art. 5(3), 2004 O.J. (L142) 8 (EC).

[28] Hungary and Slovenia have a triggering point of 25% voting rights; Austria, Belgium, Cyprus, Germany, Finland, Ireland, Italy, the Netherlands, Spain and Sweden have a triggering point of 30% voting rights; Greece, France, Luxembourg and Slovakia have a triggering point of 1/3 voting rights (33.33% voting rights);Czech Republic and Lithuania have a triggering point of 40% voting rights; Latvia, Malta and Portugal have a triggering point of 50% voting rights; Poland has a triggering point of

Interestingly, in Denmark and Estonia, there is no threshold which triggers the application of the mandatory bid rule. The rule applies whenever the acquirer "holds the majority of voting rights in the company or becomes entitled to appoint or dismiss a majority of the members of the board of directors"[29]. Despite the minute threshold difference between the U.K. and EU member states, once the mandatory bid rule is triggered, the acquirer has to bid for all the company shares through a general tender offer. No partial tender offer is allowed except for extreme circumstances.

B. The Mandatory Bid Rule in China

In contrast with the U.K. and EU countries, partial tender offer is an important part of the current Chinese mandatory bid rule. Only in rare situations does the acquirer have to send out general tender offer.

Furthermore, while China has the same "30% trigger" of mandatory bid rule with the U.K. and most E.U. member states, the Chinese trigger contains 30% of the issued shares and 30% of the total shares, and the consequences of the mandatory bid rule are different accordingly. In Chinese listed companies, noncurrent shares are very common. The Share Split Reform implemented since 2005 made part of the non-tradable shares tradable, but a large fraction of shares are still strictly restricted from selling even until now.[30] As we will explain in the following context, the prevalence of noncurrent shares widens the discrepancy between 30% issued shares and 30% total shares. Meanwhile, the consequence of the mandatory bid rule is also different, depending on how the acquirer reaches the trigger in the first place.

If a purchaser reaches 30% of the issued shares of a listed company by securities trading at the stock exchange or by tender offer from the beginning, the purchaser can freely choose to send out either a general tender offer or a partial offer for further acquisition.[31] The proportion of target shares through a partial offer shall not be less than 5% of the issued shares of the listed company.[32] Meanwhile, if this purchaser reaches 30% of the total shares of the listed company, he can still choose to send out a partial tender offer increasing no less than 5% shares at his will.

66% voting rights. *See* COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT ON THE IMPLEMENTATION OF THE DIRECTIVE ON TAKEOVER BIDS, Brussels 21.02.2007 SEC(2007) 268, annex 4, http://ec.europa.eu/internal_market/company/docs/takeoverbids/2007-02-report_en.pdf.

29 *Id*.

30 Linyao Tang, *敵対的買収規制における権力配分: 中国の信認義務, 取締役会の中立義務の規制および株主の権利の再考* [*Power Allocation in Hostile Takeover Regulation: Rethinking Chinese Fiduciary Duty, Board Neutrality Rule and Shareholder Rights*], 47 TOHOKU L. REV. 115 (2017). The Share Split Reform beginning in 2005 only made a portion of the non-tradable shares of the State tradable and just moderately reduced the level of ownership concentration.

31 *See* 2014 Takeover Measure, *supra* note 13, art. 24.

32 *Id.* art. 25.

Therefore, it is safe to conclude that the mandatory bid rule is not a strict requirement for tender offer acquirers. Partial tender offer is applicable at both 30% of the issued shares and 30% of the total shares. Furthermore, even if the purpose of the acquirer is to delist the listed company through takeover, this acquirer still does not have to send out a general offer. All he needs to do is to unconditionally accept all the preliminarily accepted shares including those exceed the acquirer's designated amount.[33]

If a purchaser reaches 30% of the issued shares of a listed company through negotiations, the purchaser can freely choose to send out either a general tender offer or a partial offer for further acquisition.[34] However, once his shareholding reaches 30% of the total shares of the company, he has to send out a general offer for all shares of the company.[35] Therefore, for acquisitions through negotiations, the mandatory bid rule is relatively strict. Once the acquirer reaches 30% of the total shares of the company, the only way to further increase his shareholding is general tender offer.

If any person is entitled to 30% of the issued shares of a listed company through any lawful means other than acquisition through tender offer or negotiation, then he shall send out a general offer for all shares of the company.[36] In short, the mandatory bid rule is strictest for indirect acquirers. Once 30% threshold is reached, general tender offer is compulsory.

To sum up, the Chinese mandatory bid rule requires acquirers holding 30% of the issued shares and acquirers holding 30% of the total shares to send out either partial tender offer or general tender offer under different circumstances, for part or all outstanding shares of the company. In other words, whenever an acquirer or investor, individually or collectively, steps over the 30% issued shares threshold, tender offer appears to be the only legitimate way of acquisition. But whether general tender offer is compulsory varies from cases.

Obviously, partial tender offer is more cost-efficient than general tender offer.[37] After all, general tender offer is way too costly and usually leads to the failure of the whole takeover proposal. On the other hand, the general tender offer can provide shareholders with far more certainty and convenience by ensuring that all shareholders have

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33 *Id.* art. 37.
34 *Id.* art. 24.
35 *Id.* art. 47.
36 *Id.* art. 56.
37 Frank H. Easterbrook & Daniel R. Fischel, *The proper role of a target's management in responding to a tender offer*. HARV. L. REV. 1161–1204 (1981) (partial offer is definitely cheaper, the acquirer only have to acquire as much shares as he needs).

the equal chance to sell out their shareholdings at a premium.[38] Under current Chinese law, stepping over the 30% trigger point through normal securities trading or tender offer provides acquirers in China with the legitimate right to send out partial offer in takeovers instead of having to bid for all the outstanding shares. From this aspect, the Chinese mandatory bid rule is more acquirer-friendly, rather than shareholder-supreme. It promotes hostile takeovers from happening at the cost of minority shareholder protection. In reality, in partial tender offers, when preliminarily accepted shares exceed the purchasers' original plan, certain percentage of shares are possessed in the hands of shareholders, price of which may very likely plummet after the takeover. In addition, the minority shareholder may take a critical roll once an acquirer chasing short-term gain consolidates its control power of the target company, as repeatedly observed in Chinese securities market.

III. THE TECHNICAL RULES FOR THE ACQUIRERS

Under certain conditions, a full-scope general tender offer may become mandatory after a partial tender offer takeover. The *Takeover Guideline* and the *2014 Securities Law* simultaneously endow minority shareholders with the right to empty their shareholdings when the equity distribution of the target company does not conform to the requirements for listing in stock exchanges any more. The shareholders other than the acquirer who still holds shares of the target company have the right to sell their shares to the acquirer who caused the alternation of equity distribution under the same conditions in the partial tender offer, and the acquirer must purchase all those shares.[39] In other words, if the acquirer purchased the shares of a listed company through partial tender offer to the extent that the company is no longer eligible for listing, then the partial tender offer ultimately becomes a general tender offer, and the acquirer is responsible for all the shares that other shareholders want to sell. Those shares remained in other shareholders' hands are either the shares shareholders did not plan to sell originally, or the preliminarily accepted shares that exceeds the acquirer's designated amount in previous tender offer; and now, they all become the acquirers' responsibility.

A. The Sell-Out Right

The Chinese regulation is quite similar to the sell-out right specified in the *European Directive*. The *Takeover Directive* offers minority shareholders a sell-out right, which enables them to request

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38 *Id*. (comparing with partial offer, general offer provides minority shareholders more protection).
39 *See* 2014 Securities Law, *supra* note 2, art. 97. *See also* 2014 Takeover Measure, *supra* note 13, art. 44.

the majority shareholder bidder to buy their securities following a takeover offer if the bidder holds securities representing 90% of the capital carrying voting rights and 90% of the voting rights in the target company. This sell-out right goes hand in hand with a squeeze-out right that allows a majority shareholder bidder to request the remaining minority shareholders to sell out their shareholdings at a fair consideration.[40] Under either situation, the acquirer (or the majority shareholder) must pay a reasonable share price in cash or equivalent transferable securities in the previous tender offer. The rights to sell-out and squeeze-out are a preemptory norm for all member states. Shareholders can exercise these rights within three months after the tender offer takeover. In practice, while most member states have a 90% threshold for the sell-out and squeeze-out rights, over one fourth of member states increased their threshold to 95%[41]; Latvia and Luxembourg set a 90% threshold for the sell-out right and 95% threshold for the squeeze-out right.[42]

In China, the sell-out right does not have a corresponding squeeze-out right, and shareholders are not directly entitled to the sell-out right itself. Every member state of the E.U. has a specific threshold for shareholders to exercise the sell-out right, but in China, the sell-out right triggers automatically once the company loses its listing status, regardless of the bidder's shareholding percentage, nor the public shareholders' will.

Article 51 of the *2014 Securities Law* illustrates the requirement of equity distribution if a company plans to be officially "listed". The public-offered shares shall be more than 25% of the total shares of the company; and for companies with a registered capital over 400 million RMB, the percentage of its public-offered shares shall not be less than 10% of its total shares.[43]

The public-offered shares refer to shares held by public individuals rather than legal persons or institutions.[44] Suppose a small listed company with 100% circulating shares (an "absolute public" company). According to the Chinese Law, if any acquirers obtained 75% of the company share, the company is no longer eligible for listing, and the acquirer has to afford all the remaining shares of the

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[40] Council Directive 2004/25, art. 15, art.16, 2004 O.J. (L 142) 8 (EC).

[41] Austria, Czech Republic, Cyprus, Denmark, Estonia, Greece, Finland, Hungary, Ireland, Malta, Poland, Portugal, Spain, Slovenia and Sweden have a 90% threshold for both the sell-out and the squeeze-out right, while Belgium, Germany, France, the Netherlands, Italy, Lithuania and Slovakia have a 95% threshold for both the sell-out and the squeeze-out right. *See* COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT ON THE IMPLEMENTATION OF THE DIRECTIVE ON TAKEOVER BIDS, Brussels 21.02.2007 SEC(2007) 268, annex 4, http://ec.europa.eu/internal_market/company/docs/takeoverbids/2007-02-report_en.pdf.

[42] Id.

[43] *See* 2014 Securities Law, *supra* note 2, art. 51 (3).

[44] *See* Note, *supra* note 12.

company. In this case, the threshold for shareholders exercising their sell-out right is 75%. However, in most listed companies in China, legal persons and institutional investors usually possess a certain percentage of shares, and most listed companies more or less have some non-public shares[45], thus the threshold for exercising the sell-out right of public shareholders is even lower than 75%. Under extreme situations, a company may not be eligible for listing if any acquirers obtained even less than 30% of the issued shares.[46]

B. Shortcomings of the Chinese Sell-out Right

In any case, the acquirer should not be the only one to bear the consequences of privatization of listed company. When the purpose of the acquirer is to delist the target company, it is reasonable that the acquirer shall unconditionally accept all the preliminarily accepted shares including those exceed the acquirer's designated amount, but demanding the acquirer to swallow all the company shares simply because the ownership distribution falls out of the listing norm is not reasonable at all. For instance, an acquirer with 30% shares plans to further purchase 5% shares through tender offer; meanwhile, other majority shareholders with more than 5% shares of the company slightly increase their shareholding by 4.99%, which is slightly below the 5% line to make public announcement.[47] Under this circumstance, if the company loses its listing status, requiring the acquirer alone to buy out all the trivial shares is not fair at all, because all other majority shareholders contribute to the status quo.

The legislative purpose of sell-out right is to protect the rights and interests of minority shareholders by offering them a fair opportunity to exit. In European countries, for a bidder with 90% of the capital carrying voting rights and 90% of the voting rights in the target company, taking care of the residual is not a big deal. On the contrary, in China, the bidder has to take care of the remaining 25% and usually more shares of the company, yet very likely the bidder is still far away from being a "controlling shareholder" when this happens. In China and most countries, very few acquirers intend to buy out the whole company in takeovers. Majority only bid for necessary proportion of shares which is considered necessary. After all, acquisitions are too costly. In China, acquirers are responsible for formally reporting to CSRC the quantity and proportion of the designated shares, amount of capital required for the takeover, and sources and guarantees of capital

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45 Amighini, Alessia A., Roberta Rabellotti & Marco Sanfilippo, *Do Chinese state-owned and private enterprises differ in their internationalization strategies?* 27 CHINA ECON. REV. 316 (2013).
46 Some companies issued exactly 25% or 10% public shares, and the rest 75% or 10% are all non-public shares inside the company, thus any takeover attempt by a third party other than an individual may cause the listed company on the edge of losing its listing status.
47 *See* 2014 Takeover Measures, *supra* note 13, art. 14 and art. 16. In share transactions, 5% is the trigger of mandatory report obligation.

before sending out tender offer.[48] Acquirers are also required to prove that they are financially sustainable for the designated tender offer. Nonetheless, most of the acquirers are far from well prepared for purchasing the remaining shares after the tender offer. Without sufficient funds, the sell-out right of shareholders is just words on page, yet it is not realistic for the law to require all acquires preparing enough money for all outstanding shares of the company in partial tender offers.

In some cases, the amount of remaining shares is even bigger than the amount of shares acquirer predetermined to bid. Requiring the bidder to satisfy the sell-out right of the shareholders may result in the acquirers' opportunistic behavior, forcing them to dismantle the target company for quick cash.

Even if the acquirer does have to ability to afford the remaining shares, and obtains 100% shares of the target company in the end, drawbacks still occur. Equity investor is now forced to be responsible for a business he is not fully familiar with. This may not serve the best interest of the company, given that the company may achieve greater development under the control, or joint-control of former industry professionals. Indeed, when exercising the sell-out right, the minority shareholders' interests are under thorough protection and they can exit the company in a fair manner, but the costs are to be borne by the employees, creditors, affiliated companies and others who have connections with the target company in the long run.

IV. THE TENDER OFFER DEROGATIONS

Sell-out right is only the tip of the iceberg of the tender offer regulations. The derogations of the tender offer in China are the most problematic. While in the law of U.K. or E.U. exempts acquirers from the "mandatory bid rule" in certain conditions, the Chinese Law directly exempts acquirers from the tender offer.

A. Two Types of Tender Offer Derogation in China

In China, there are two types of tender offer derogations – application-based derogations and non-application-needed derogations.[49]

Normally, the investors and its concerted parties have to apply to the CSRC for the derogation of tender offer, and CSRC shall respond to the application within 20 days by explicitly granting the derogation or passively not bringing any objections.[50]

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48 *See* 2014 Takeover Measures, *supra* note 13, art. 29(1)(4)(6).
49 *See* 2014 Takeover Measure, *supra* note 13, art. 61, art. 62.
50 *Id.* art. 62 (3).

However, under following circumstances, investors and its concerted parties can skip the application, and directly undergo the procedures of share transfer and registration in Stock Exchange and in China Securities Depository and Clearing Corporation Limited (CSDC) respectively. First, if the derogation of tender offer is approved by non-affiliated shareholders on general assembly of shareholders, and the investor with more than 30% of the company issued shares undertakes not to transfer the new shares within the future three years. Second, investor with more than 30% of the company issued shares undertakes to increase its shareholding no more than 2% every 12 months in the future. Third, investor with more than 50% shares continue to increase its equity in the company but will not affect the listing status of the company. In addition, if the investor stamped the 30% line for reasons independent of his will, for instance, fulfillment of formerly agreed share repurchases schemes, inheritance, common brokerage and loan business of financial entities or retrieve of voting rights of the preferred stock, the application to CSRC for derogation is also unnecessary.[51]

Unless under the circumstances mentioned above, when stepping over the 30% mandatory bid line, investors and its concerted party have to make formal written applications to *CSRC* for the derogation of tender offer. The application-based derogation has two sub-categories – exemption from increasing shares by means of tender offer and exemption from sending a tender offer to all shareholders of the target company.

Purchaser can apply to CSRC for the exemption from increase of shareholding by a tender offer in the following two situations. First, if the purchaser and transferor can prove that the share transfer will not cause alternation of control, as the transaction itself is in-between the entities under the same actual controller. Second, if the listed company is in serious financial distress and the investor intends to save the company through a reorganization scheme approved by the general assembly of shareholders. Investor with a reorganization scheme must promise not to transfer its shares to any party within three years.[52]

Upon receiving the application, *CSRC* shall clearly grant or refuse the derogation application within 20 working days. If *CSRC* rejects the derogation application, the investor and its concerted party shall either reduce their shareholding to 30% or less, or send out a general tender offer to all shareholders to bid for all outstanding shares if they persist to acquire more shares of the target company. If the derogation is granted, not only can the investor freely bid for any proportion of shares (more than 5%) through tender offer, but he can also increase his shareholding through means other than tender offer as well.

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51 *Id.* art. 63.
52 *Id.* art. 62.

Generally, negotiated acquisitions are much more preferred than acquisitions through tender offer, as it is less cost-consuming but more time-efficient.[53]

Purchaser can apply to CSRC for the derogation from sending a tender offer when gratuitous transfer, alternation or combination of state-owned assets approved by the government or the State-owned Assets Supervision and Administration Commission (SASAC) of the State Council causes the 30% shareholding fact. In addition, a security holder does not have to send out a tender offer at all, if his shares exceed 30% of the issued shares of the company due to shareholder assembly approved share repurchase aiming at reducing the public share circulation. Upon sending the application, if the security holder does not receive any objections from the CSRC within 10 days, then the security holder can fulfill the share transfer and registration process directly without sending any tender offer. In fact, applicants for the derogation from sending a tender offer are just normal securities holders, rather than purchasers or acquirers of the listed company; they hardly have any intentions to increase their shareholdings, not to mention acquiring the whole company.[54]

In short, Chinese law grant investors the right to exempt tender offers when: first, share purchase that will not cause transfer of control of the company; second, acquisition of shares approved by general assembly of shareholders; third, long-term shareholder increases its shareholding in a gentle manner; fourth, share-increase beyond the investors' will.

B. Loopholes and Deficiency of Tender Offer Derogation

The logic and reason behind current tender offer derogation regulation is obvious. The law is to prevent acquirers from taking advantage of the tender offer derogation for short-term disproportionate returns.

First, when share purchase does not cause transfer of control, it seems that the stabilization and sustainable development of the company is insusceptible; the production and management activity almost remain exactly the way they were. It is especially true when the actual controller himself increases his shareholding – firmer control of the company means less constraints on decision-making. Second, in acquisitions approved by general assembly of shareholders, the acquirer usually acts for either the interest of the major shareholders or the long-term benefits of the company; the acquirer has no hostile intentions and his acquisition is via friendly negotiations and considerations. Third, investors promise not to transfer their shares

53 *Id.*
54 *Id*. art. 63.

within three years have no chance to gain from short-term plunder behavior, they have bind themselves with the future three years' development of the target company. Fourth, that a shareholder increases its shareholding slowly at least ostensibly indicates that temporarily he has no desire for corporate control. At a limit of no more than 2% every 12 months, corporate raiders with high leverage-ratio capitals or those intending to dismantle the company for sale can do nothing but to give up their evil notions. Fifth, if the increase in the share is beyond the security holders' will, it is hard to imagine that the security holders will make a fuss out of it.

At first glance, those regulations can indeed ensure that investors who increase their shareholdings will behave properly in the short term, but not for long. For instance, at the beginning, a founder and shareholder holds 51% shares of his company, and the remaining shares are for financial purposes of expanding the company's scale. Gradually, when business is booming and the controlling shareholder realizes that it is not cost-effective to share profits with minority shareholders, he may easily squeeze them out by any means other than tender offer to the marginal extent that the company stays "listed". The agency cost between majority shareholders and minority shareholders is especially high in companies with concentrated ownership[55], and Chinese law particularly exempts the block shareholders from increasing shares through tender offer. In this case, from the beginning to the end, minority shareholders cannot enjoy the premiums of the tender offer and their interests are at stake.

A more common scenario in China is as follows: a financially sound institutional investor acquires 30% shares of a company via negotiation and other means. This shareholder then stays quiet and every 12 months, he increases 2% shareholding. According to Chinese Law, he does not have to send out tender offer for share increases, nor does he have to make any public announcements at all. After two years, when this shareholder acquires approximately 34% of the company's share, he obtains the veto power over virtually every major issue of the company. According to Chinese Company Law, any decision to revise corporate charter, increase or reduce registered capital, merge, split up, dissolve or change company's form shall be adopted by shareholders representing 2/3 or more of the voting power.[56] As in China, the Company Law largely ensures one-share-one-vote[57] mechanism; thus shareholder with 34% company shares

[55] Frank H. Easterbrook, *Two agency-cost explanations of dividends*, 74.4 AM. ECON. REV. 657 (1984).
[56] Gongsi Fa (公司法) [Company Law] (promulgated by Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994) (2013) art. 43 (Chinalawinfo).
[57] *Id*. at Art. 126. In China, the issuance of shares shall comply with the principle of fairness and impartiality, the shares of the same class shall have the same rights and benefits. The stocks issued at the same time shall be equal in price and shall be subject to the same conditions. The price of each share purchased by any organization or individual shall be the same.

normally has 34% voting power of the company. In this case, when the board of the directors realizes the potential hostile intentions of the shareholder, it is already too late.

Under the "2% per year Rule", a Chinese shareholder can without any restriction increase his shareholding without sending out tender offer, which is unimaginable in European countries. Early in 1971, U.K., Norcos Corporation announced its intent to acquire Venesta International. To prevent the company from takeover, an individual shareholder, Mr. David Rowland, began purchasing the company shares in secondary market. Despite the fact that the share purchase was extremely difficult and went rather slow, Mr. David Rowland eventually became the controlling shareholder of Venesta International.[58] Nocors Corporation then made a complaint to the Panel on Takeovers and Mergers who later realized that Rowland's open market bulk buying "denied the company's small shareholders the opportunity to sell at the favorable terms Rowland had offered"[59]. Based on this case, a new rule was added into the *1972 City Code on Takeovers and Mergers* which requires any person who purchases 40% or more of a company's shares to make a bid for the remainder, no matter how gradual he obtains those shares.[60] This rule lay the foundation for the long-standing mandatory bid rule in *City Code on Takeovers and Mergers.*

In China, astute institutional investors can utilize other loopholes in tender offer derogation to usurp and seize the control of listed companies. For example, when an investor promises not to transfer his shares within 3 years and obtains approval from non-affiliated shareholders, he automatically qualifies for derogation from tender offer without notifying CSRC.[61] Indeed, this investor has to hold the shares of the company for 3 years, but this does not change the fact that he has obtained relative control of the company without offering an exit mechanism to minority shareholders through a public tender offer. In China, social ties play critical part in many aspects of business. In the corporate world, while non-affiliated shareholders are supposed to be "non-affiliated", such a title does not cut their social ties with corporate insiders such as majority shareholders, actual controller of the firm or the controlling shareholder.[62] These bonds arise out of educational background, industrial overlap, shared

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58 Prentice, D., *Take-Over Bids--The City Code on Take-Over and Mergers*, 18 MCGILL L.J. 385 (1972).

59 Armour, John & David A. Skeel Jr., *Who writes the rules for hostile takeovers, and why-the peculiar divergence of U.S. and U.K. takeover regulation*, 95 GEO. L.J. 1764 (2006)

60 The City Code on Takeovers and Mergers, *supra* note 3.

61 *See* 2014 Takeover Measures, *supra* note 13, art. 62.

62 The title of "independent" or "non-affiliated" cannot fully cut the social ties in-between the parties involved. In practice, crucial figures to the company more or less connect with the crucial figures of the company, such as CEO, CFO, manager, actual controller of firm or the controlling shareholder.

regional origin, military service or even third-party connection, representing informal connections that are not captured in conventional measures of "non-affiliate".[63]

In short, a major flaw of Chinese tender offer regulation is that, once the applicant obtains derogation from CSRC, he could find a way to circumvent tender offer forever. "Once exempted, always benefited" This leaves abundant room for majority shareholders to outsmart minority shareholders.

V. SOLUTION & CONCLUSION

A. Mandatory Bid rule: A Rational Trigger

The Chinese mandatory bid rule has an initial trigger of 30% issued shares, while U.K. and most E.U. member states have a threshold at 30% shares carrying voting power. Considering the non-tradable state-owned shares account for a proportion which is impossible to ignore in total shares of most listed companies, the initial trigger point of Chinese mandatory bid rule is in fact much lower than U.K. and major E.U. member states. For a wide range of minority shareholders, it might be a good thing; but such a low-threshold mandatory bid rule inevitably prevents takeovers from happening in the first place. Fewer takeovers mean even fewer exit channels for minority shareholders; thus it is hard to say such a low-threshold mandatory bid rule is in the interest of minority shareholders.

In China, minority shareholders have a nickname of "chives", because they are easily "harvested" by majority shareholders in the Chinese stock market. The knotty problem behind is the much poorer corporate governance environment in China compared to its counterparts in the U.K. or the E.U.

The biggest corporate governance problem in China is the agency costs of controlling shareholder and insiders' control as well as the absence of functional proprietor of the state-owned shares. State-owned shares account for a considerably large proportion in Chinese listed companies. However, the State-owned Asset Supervision and Administration Commission performed badly over the past two decades, and the state-owned largest shareholder as the supervision entity of the management is virtually non-existent, causing even severer insider control problems.[64]

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[63] In Qiye Kuaiji Zhunze Di 36 Hao (企业会计准则第36号) [Accounting Standards for Enterprises No.36] (promulgated by Ministry of Fin., Feb. 15, 2006, effective Jan. 1, 2007) (Chinalawinfo), there are a series of listing rules as well as a negative list defining what exactly "affiliated party" is, but those definitions largely ignored the social connections between related parties.

[64] Huang Xingluan (黄兴孪) & Shen Weitao (沈维涛), Zhengfu Ganyu, Neibu Ren Kongzhi yu Shangshi Gongsi Binggou Jixiao(政府干预、内部人控制与上市公司并购绩效) [A study on Government Intervention Insider Control and M&As' Performance of Chinese Listed Companies], 6 JINGJI GUANLI (经济管理) [ECON. MGMT. J.] 31, 70–76 (2009).

Moreover, the supervisory board and independent director system function awfully in China.[65] Due to poor institutional transplantation, it is almost impossible for the supervisory board to "supervise" the management, and independent directors in China are simply "rubber stamps" for the board of directors.

Under these conditions, when China gradually opens its capital market, takeovers, especially hostile takeovers, may be an ultimate cure to Chinese corporate governance. In 2016, the Chinese government adopted supply-side reform to vitalize Chinese enterprises. Therefore, the whole industries are in desperate need of takeovers and reorganizations to better utilize social resources. In short, a higher threshold of mandatory bid rule that facilitates takeovers is more optimal for China.

Even from the aspect of the policymakers, setting low trigger is a way to protect minority shareholders, but allowing partial tender offers to overflow the security market is quite the opposite. In U.K. and all E.U. member states, once acquirers trigger the mandatory bid rule, general tender offer becomes compulsory while partial tender offer is strictly prohibited. This is to ensure equal and fair treatment of all shareholders without any omission. From the experiences of U.K. and E.U., when obtaining shares to the extent of triggering the mandatory bid rule, the acquirer usually holds sufficient voting power that may confer control, and the minority shareholders are in a weaker position. Therefore, the compulsory requirement of general tender offer only has very little inhibiting effect on takeovers, but can improve minority shareholders' situation significantly.

In sum, current Chinese mandatory bid rule has so low a trigger that hostile takeovers can hardly happen. Meanwhile, partial offers instead of general offers are too frequently allowed in takeovers that the interests and lawful rights of minority shareholders are ignored. A higher trigger, combined with a stricter general tender offer requirement, is optimal and imminent for Chinese securities market. Meanwhile, considering state-owned shares percentage varies, and almost every listed company in China has its unique equity distribution, a flexible trigger is crucial. Denmark and Estonia has set a good example for China: "whenever an acquirer holds the majority of voting power in the company or becomes entitled to appoint or dismiss a majority of the members of the board of directors, he shall launch a general tender offer for all the outstanding shares of the target company."[66] As when the acquirer could be deemed as "holding the

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[65] Wang Yuetang (王跃堂), Zhao Ziye (赵子夜) & Wei Xiaoyan (魏晓雁), Dongshihui de Dulixing Shifou Yingxiang Gongsi Jixiao? (董事会的独立性是否影响公司绩效?) [Does Independence of the Board Affect Firm Performance?], 5 JINGJI YANJIU (经济研究) [ECON. RES. J.], 62–73 (2006).

[66] Tang, *supra* note 30.

majority of voting power in the company or becoming entitled to appoint or dismiss a majority of the members of the board of directors, it is optimal for the general assembly of shareholders to decide, instead of a fixed standard from CSRC.

B. Sell-out Right: A Reasonable Burden Sharing

In European Takeover Directives, where a bidirectional sell-out right and squeeze-out right coexist with each other, whether to exercise these rights or not depends on acquirers' or shareholders' will. When this happens, the acquirer has obtained more than absolute control of the company, while the minority shareholders' together hold only an insignificant amount of the company's shares. In China, only sell-out right is granted to majority shareholders, and the trigger of the sell-out right is much lower than that of E.U. member states.

Maximizing shareholders' value and protecting minority shareholders' interests is crucial in any countries' company law. Nevertheless, it is also crucial to realize that, an acquirer, or a bidder *per se*, is a shareholder of the company. General tender offer, like any other tender offers, usually opens to public for more than 30 days. After the general tender offer, shares in other shareholders' hands are shares that they do not want to sell after thorough consideration. In many cases, when equity distribution of the company does not match the requirements set forth in securities law, the acquirer is still far away from becoming a controlling shareholder. In companies with institutional investors as the majority shareholders, or in companies with state-owned shares as the majority, even if the acquirer buys out the remainders, he cannot become the *de facto* controller of the company.

Usually, a listed company losing its listing status is not solely due to an individual acquirer's purchase. When momentum is strong, any shareholder of the company may slightly increase their shareholdings, including the majority shareholders and institutional shareholders. Thus, the acquirer should not be the only one to accept the residual shares when shareholders exercise the sell-out right.

Luckily, when a listed company is at the edge of delisting, CSRC will notify the acquirer, and the acquirer can choose to reduce his shareholding to such an extent that the company stays listed; but again, the responsibility unfairly falls on the shoulder of the acquirer alone.

In sum, the threshold of the current Chinese sell-out right is too low; like most E.U. member states, 90% is an optimal line for shareholders' sell-out right. Moreover, it is rational that when minority shareholders exercise the sell-out right, all majority shareholders (according to their *shareholding ratio*) are altogether responsible for the remnant shares, but the acquirer reserves a preemptive right to acquire all the remnant shares. Meanwhile, if the acquirer chooses to reduce his shareholding to keep the company staying listed, then he has the right to request other majority shareholders to do the same (according to their *share-increasing ratio*).

C. Derogations of Tender Offer: A Time Limit and Share Increase Amount Limit in Need

In *the City Code*, there are certain exceptions to the mandatory bid rule. For example, issuance of new securities approved by shareholders as consideration for an acquisition, rescue operation, acquisition of shares because of inadvertent mistake, holders of shares carrying 50% of the voting rights state that they would not accept the offer, etc.[67]

The *European Directive* grants the supervisory authority of each member state the power to waive mandatory bid rules in order to take account of specific circumstances. Even so, Cyprus, Hungary and Latvia did not stipulate tender offer derogations. Thus, in those countries, a general tender offer for all shares of the target company is unavoidable once the mandatory bid rule is triggered. In other member states, normally, Mandatory Bid obligation does not apply to acquisitions by inheritance, gift, debt enforcement or marriage. Besides, the supervisory authorities of other member states grant acquirers derogations from mandatory bid rule for other various reasons. The most common ones are that changes of control is within the same group[68], restructuring or rescue scheme[69], temporary stepping over the mandatory bid threshold[70], dominant influence was gained for the purpose of carrying out a merger or division[71], acquisition of control as a result of the exercising of pre-emption rights[72], stepping over the Mandatory Bid threshold as a result of measures taken by the target company or by another shareholder[73] and so on.[74]

Some member states have unique mandatory bid rule derogations. For example, shareholders cannot exert a significant influence on the target company (Austria), another person holds a higher percentage of voting power (Finland), and the offeror has already obtained *de facto* control of the company below the mandatory bid rule threshold (Germany). They are all distinctive reasons for the derogations of the mandatory bid rule.[75]

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67 *See* The City Code on Takeovers and Mergers, *supra* note 3, § F1, Rule 9.
68 Czech Republic, Denmark, Estonia, France, Italy, Lithuania, Poland and Spain.
69 Belgium, Lithuania, Netherlands, Poland, Portugal, Spain.
70 Czech Republic, Greece, Spain, and Finland.
71 Estonia, Italy, Greece and Malta.
72 Malta, Greece and Netherlands.
73 Finland, Slovenia.
74 COMMISSION OF THE EUROPEAN COMMUNITIES, *supra* note 29, annex 3.
75 *Id.*

Compared with U.K. or E.U. member states, Chinese law on tender offer derogation is too complex. The derogation of tender offer is divided into application-based and non-application-needed; moreover, the application-based are further divided into two categories – one from increasing shares by means of tender offer and another from sending a tender offer to all shareholders of the target company. Even worse, the languages and expressions in relevant provisions are rather obscure and vague. Sweeping generalizations in twisted clauses unexpectedly leave more loophole for investors with ulterior motives. In comparison, derogation regulation is more substantial and strict in U.K. and E.U. member states; the literal meaning of the clauses is quite simple but crystal clear.

In addition, for U.K. or E.U. member states, acquirers are just exempted from the mandatory bid rule, but in China, acquirers are actually exempted from the tender offer. In U.K. or E.U. member states, even if acquirers obtain derogation from the mandatory bid rule, normally, the only way they could further increase their shareholdings is through tender offer; the acquirers just do not have to bid for all outstanding shares of the company. In contrast, in China, once the applicant has confirmed their derogation from the CSRC, they can almost increase their shareholdings through whatever means possible. In practice, acquirers in China are scrambling to avoid even partial offers once they obtain the derogation, and the minority shareholders are thereby isolated from negotiation table.

In sum, the Chinese mandatory bid rule derogation is too loose, and acquirers can freely increase their shares through ways other than tender offer once they obtain the derogation. Only tender offer, especially general tender offer for all outstanding shares, can provide minority shareholders with sufficient guarantee; and derogations of mandatory bid rule should not be a convenient weapon for corporate control. In view of this, a time limit of derogation as well as an amount limit of share-increase is urgent for the current legislation. First, three years after the derogation of tender offer, if the investor still holds more than 30% shares of the target company, further acquisition of shares must through a general offer for all outstanding shares of the company. Second, less than three years after the derogation of tender offer, if the investor obtains more than 40% of the company share, further acquisition of shares must be conducted through a general offer for all outstanding shares of the company.