# A Hybrid Improvement on Board's Role to Block Hostile Takeover

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**Abstract.** Whether boards should be allowed to block hostile takeovers is a complicated issue. Based on different value orientations, U.S. and U.K. set contrary regulations. Under U.K. regulations, the board of corporation shall apply the "No frustration" principle when corporation faces a takeover from another entity. While the regulations of the U.S. allow the board to defend hostile takeover by imposing a series of measures under the standards of Unocal and Revlon, current regulations are imperfect in that they are unable to correct the actions of the board timely. Therefore, the needs for improvement to protect shareholders' interests still exist. Aiming to shareholder value maximization, this article proposes a possible solution for improvement and calls on an open environment of power allocation between board and shareholders.

**Keywords:** hostile takeover; board; shareholder.

## 1. Introduction

Takeover is a form of corporate restructuring, that one corporate comes under the control of another corporation [1]. Takeover includes two types, which are friendly takeover and hostile takeover, that distinguished by the willingness of board. In a friendly takeover, the board of target corporate considers whether the offer is satisfied and appropriate, and willing to recommend the shareholders to accept it. On the contrary, a hostile takeover is an acquisition which the board of target corporate is informed or does not agree for various reasons [2].

The history of hostile takeovers of U.K. began in the 1950s [3]. Since the 1960s, the hostile takeover also gradually displaced the position of proxy contest as the more popular mechanism for acquiring corporate in U.S. [4]. While hostile takeover started to be used widely, these two jurisdictions developed different concepts, which are shareholder primacy for U.K. and director primacy for U.S. Under those principles, board plays different roles when the corporate faces a hostile takeover, and a controversy thereby rise, that which pattern is better, or neither.

## 2. Regulations of U.K. and U.S. on Boards' Role in Facing Hostile Takeovers

### 2.1 U.K. Regulations

In 1959, the Bank's committee adopted the Notes on Amalgamation of British Businesses. With the aims to "concerned primarily to safeguard the interests of shareholders", the Notes contained a series of general guidelines and the shareholder primacy was thereby established [5]. Shareholder primacy generally concludes (1) that shareholders are the principals on whose behalf corporate governance is organized and (2) that shareholders do (and should) exercise ultimate control of the corporate enterprise [6].

Specifically, U.K. regulations have limited the board's ability when the corporate faces a hostile takeover by the "No Frustration Rule" in the City Code on Takeovers and Mergers. According to the City Code (1968, r 21(1)(a))., "the board must not, without the approval of the shareholders in general meeting, take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merit." when the corporate faces a hostile takeover. To apply the "No Frustration Rule", the board of target can hardly react to the hostile takeover since they are not allowed to frustrate any offer.

However, such a harmless board would incur disadvantages for corporate when it faces a hostile takeover. Without the authorization to frustrate, board and corporate would lose the ability to bargain at the same time. Sometimes the shareholders would choose to accept the inadequate offer only because the better offer has not yet appeared.

### 2.2 U.S. Regulations

On the contrary, the boards in the U.S. have much more space to defend hostile takeover because of the concept of director primacy. Delaware code (Ann. tit. 8, § 141(a)) puts that, the corporation’s business and affairs “shall be managed by or under the direction of a board of directors.” Therefore, such statutory decision-making model allows the board acts and shareholders only can react. In brief, the power to defend is controlled by the board rather than the shareholders [7]. As a positive theory of corporate governance, director primacy claims that fiat —centralized decision-making— is the essential attribute of efficient corporate governance [8]. Under board primacy, shareholders are unlikely to control the corporate either in direct or indirect mechanism, for the shareholders are considered to have the demand to control. Instead, the board enjoy the power to control corporate both on fact and legal aspects. [9].

Delaware common law has corroborated the right of boards to defend hostile takeover through several representative cases, and states such as New York and Pennsylvania have also confirmed the boards' right by legislation [10]. To prevent boards from injuring shareholders' interests, the courts have set up two standards: the Unocal rule and the Revlon rule.

In the case of Unocal Corp. v. Mesa Petroleum Co. (1985), the Delaware supreme court held that whether the defensive strategies brought by the board are valid shall be judged under the "enhanced business judgment rule," which is a "two-prong test." Firstly, the board shall prove that it is reasonable to believe the hostile takeover would bring danger to corporate policy and effectiveness to the corporate. Secondly, the board shall prove that its defensive actions are proportionate.

The Delaware supreme court also held that when "dissolution or break-up of the corporate entity [becomes] inevitable," the role of the board shall "change [s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company" in the Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. (1986).

Both Unocal rule and Revlon rule are basing the theory of Board primacy, that the board is the one who decides whether to defend hostile takeover. The board primacy theory deprives the decision-making power of shareholders. Since the goal of corporate and board is protecting shareholders’ interest and profiting, whether to block a hostile takeover shall be decided by the shareholders themselves. Besides, Unocal and Revlon rules are remedies that only work after the damage has been incurred. It would be much better if there is a rule that prevents board from injuring shareholders’ interests in advance.

## 3. Necessities of Boards to Defend Hostile Takeover

To protect shareholders' interests, it is necessary for board having the ability to defend hostile takeover for the following reasons.

### 3.1 Efficiency

Shareholders are not as efficient as the board. Shareholders usually do not engage in the company's day-to-day operations, which leads to them not learning the corporate well as the board does. Besides, a public company might be owned by thousands and thousands of institutional and individual investors. Even though several institutional investors may own most shares, it is still impossible to convene the shareholder meeting and make decisions as efficiently as the board. Prohibiting the board from defending hostile takeover by rules like "No Frustration" only lefts the board an option to safeguard interests of shareholders, which is "White Knight." Shareholders might miss critical opportunities in defending a hostile takeover for its low efficiency with the board allowed to do hardly anything.

### 3.2 Initiative

The ability to defend brings initiative to the board, which helps to protect shareholders' interests. When a corporate face a tender offer, the measures its board takes have significate implications. Both positive and negative actions can be taken to promote or frustrate the takeover process. In defending hostile takeover, various measures can be taken to help the board defend hostile takeover, such as poison pill, golden parachute, and staggered boards. On the other side, if the board has the potential willing to promote and negotiate the takeover, takeover defenses can be taken to delay an inappropriate offer so that the board can seek out a more attractive offer [11]. Otherwise, if the board has to follow the "No Frustration" rule, the shareholders would "choose the inadequate tender option only because the superior option has not yet been presented" as the court in Shamrock Holdings, Inc. v. Polaroid Corp. (1989) held.

### 3.3 Sufficiency Information

Another advantage of allowing boards to defend hostile takeover would be similar to arguments that support board privacy, that the board is in a superior position to decide the fate of the corporate and whether or not a change in ownership would be beneficial. In Moore v Wallace Computer (1995), the Delaware courts considered that it is plausible and legitimate for board to concern that shareholders have chance to accept an adequate offer by mistake which would be recognized as inadequate according to the information learned by the board. The board, as the daily leader of the corporate, should have the most intimate knowledge, as well as the plan and potential of the company, while the shareholders usually do not have, nor inclination to thoroughly investigate and assess an offer either [12]. Although the article does not fully support the board primacy, it still illustrates the importance of allowing board to defend hostile takeover.

## 4. Deficiencies of Boards' Right to Defend Hostile Takeovers

Despite the necessity of allowing board to defend hostile takeover has been mentioned, this article tries to illustrate that whether to defend hostile takeover should not be wholly decided by board.

In fact, board primacy does not always benefit shareholders’ interests since the board has conflicts of interest with shareholders when facing a hostile takeover. The problem for the acquirer in a hostile situation is that both the board and management of the corporate can implement various defense measures that can hugely complicate, prolong the transaction, or even render the transaction impossible [13]. As agency cost theory is a common reason for takeover, the board usually faces a challenge that questions their performance and plan when a takeover bid is made. To save its jobs and reputation, the board is likely to defend hostile takeover for its own interests rather than the shareholders' [14]. This kind of argument is exactly contained by the theory of board neutrality, which the U.K. and E.U apply.

To prevent boards from defending hostile takeovers for their own interests rather than shareholders', the Delaware supreme court has set up the Unocal rule and Revlon rule as the remedies to test boards' actions. However, these two rules are both needed to be tried by courts after litigations are bought, when the possible infringement is already done, and possible damages to shareholders are already incurred. It will be much more efficient and economical if there is a way for shareholders to limit board actions in advance so that potential costs will not be wasted to complement the interests that should not be injured from the beginning. The article tries to discuss a possible solution in the next paragraph.

## 5. A possible Improvement on Current Regulations

As regulations of U.K. and U.S. both overemphasizes the role of either the board or the shareholders, corporates in these two jurisdictions are inevitably facing the demerits of one party. It would be an improvement if there is a method that can let the shareholders decide and take advantage of board at the same time.

### 5.1 Value Orientation: Shareholder Value Maximization

Before building up a system to improve current regulations, it should be clarified that protecting current shareholders' interests shall be the dominant value orientation. As the Michigan Supreme Court famously held in Dodge v. Ford Motor Co. (1919), "It is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefitting others," the essential issue of whether boards should be allowed to block hostile takeovers is how to maximize the interests of shareholders when the corporate faces a takeover.

For shareholders to enjoy the ownership of the corporate, the whole corporate, including the board, shall aim to profit for shareholders. As for the circumstance in which the corporate faces a hostile takeover, shareholders also shall enjoy the ultimate right on whether to defend the hostile takeover and whether to sell their shares, i.e., the board should not take the place of shareholders to decide whether to defend the hostile takeover or whether to sale the corporate. As the merits and demerits of shareholders and board have been mentioned, the following solution tries to exploit their characteristics.

### 5.2 Stage 1: Before the First Shareholder Meeting

In stage one, board mainly has two duties. First, Once the board has noticed that the corporate is facing a hostile takeover, it should convene the first shareholders meeting as soon as possible, since it should be the shareholders whom decide whether to defend hostile takeover.

Second, board should react to the takeover appropriately. In this stage, any frustrate actions made by board shall apply to the Unocal rule and Revlon rule. These rules give the board a warning that inappropriate actions would bring them responsibilities.

This stage is the beginning of the takeover process, in which the shareholders are unable to react immediately, yet the board can. In this stage, the board needs to make the most appropriate reactions to the takeover in accordance with its fiduciary duty. Since the shareholders have not authorized the board to react while it still needs to respond; therefore, its reactions shall apply to the Unocal and Revlon rules.

### 5.3 The First Shareholder Meeting

For the first shareholder meeting, it shall make the following decisions.

First, whether the board should defend the hostile takeover. They can decide whether to negotiate or defend the hostile takeover.

Second, the conditions that the board shall cease to defend. It brings both shareholders and board a clear condition that Revlon rule tends to estimate. Like the amount of shares the bidder has already bought or a specific price the bidder would offer.

Third, the types and extends of measures to defend. These boundaries would provide board a limited power to defend hostile takeover. So that the shareholders would less worry about whether the board would injure their interests, the board also is free from the risks of inappropriate actions as long as the board stay within the boundaries.

Fourth, the circumstance of the next shareholders meeting would be convened. The process of takeover is dynamic, and shareholders’ views might change under different circumstances. The circumstance could be specific met conditions, a specific date or the board thinks it is necessary to convene shareholders meeting again.

The board can provide professional advice on related topics to help shareholders avoid having insufficient information problems, and the shareholders are who finally decide. By making these decisions, the shareholders can fully exercise the right to negotiate the acquisition or defend hostile takeover. If the shareholders decide they are willing to sell the corporate, they can negotiate with the bidder by themselves or by boards. Otherwise, shareholders would authorize the board limited power to defend hostile takeover. Both situations express respect for shareholders' ownership and free the board from risks of violating Unocal rules and Revlon rules.

### 5.4 Stage 2: After the First Shareholder Meeting

The end of the first shareholders meeting would be the beginning of stage two. In stage two, the board's actions within the authority of the shareholders meeting are not subject to the standards of Unocal and Revlon. Otherwise, the board shall be liable for any action it takes beyond the scope of the shareholder meeting's authority. As long as the board reacts within the limits of authority, it would not concern about being responsible for violating Unocal rules and Revlon rules. If necessary, stage two can repeat again and again, until the bidder gives up or the shareholders meeting decides to accept the offer.

### 5.5 Supplement

As actions of board before the first shareholder meeting shall be tested by Unocal rules and Revlon rules and actions after shall not, a rational board would convene shareholder meeting as soon as possible to avoid potential risks. Besides, any deliberate delay in convening the shareholder meeting would be considered a violation of fiduciary duty. Therefore, it is not necessary to arrange a specific period to force the board to convene shareholder meeting.

Through this system, it can protect shareholders' interests in advance. Unlike Unocal rule and Revlon rule, the infringement of board needed to be tried by courts after litigations are bought, when the possible damages of shareholders are already incurred. Now with the set boundaries, it is easy to find out whether the board violates its fiduciary duty and inappropriate actions timely. This system could also take full advantage of board, that it allows the board to react at the beginning of a takeover and providing professional suggestions to the shareholders. Meanwhile, this system avoids the demerits of U.K. and U.S. regulations simultaneously, that shareholders' inefficient, insufficient information and interests' conflicts of board.

However, this system might not be suitable for current U.K. and U.S. regulations, since it is a kind of hybrid that mixes elements from those two jurisdictions. For the "No Frustration" rule, the Unocal rule and Revlon rule do not provide an exception and all corporates need to comply. This article considers that these two jurisdictions could allow corporates to have their own power allocation method between board and shareholders since different corporates have different characters and requirements. Such improvement mentioned might not be a cure-all for every single corporate. It will bring more flexibility if regulations allow corporates to choose their own power allocation method.

## 6. Conclusion

Basing the that shareholders and board have different characteristics, U.K. and U.S. set up two contrary rules on whether board should be allowed to block hostile takeovers. To avoid interest conflicts on the board, the U.K. introduced the "No Frustration" rule that keeps the board neutral, yet a totally harmless board sometimes harms the interests of shareholders. To avoid the shareholders' inefficient and insufficient information, the U.S. created the Unocal and Revlon rules as remedies to protect shareholders' interests. However, they exploit shareholders' decision-making power which shareholders should have enjoyed.

To improve both regulations, this article designs a system divided into two stages, in which the board has different rules of bearing responsibility by the first shareholder meeting. This system allows shareholders to exercise their ownership power by authorizing board limited power to react.

Meanwhile, this article calls on an open environment for allowing corporates to formulate their own power allocation faced with hostile takeover.

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