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Should China Adopt a Mandatory Bid Rule?

Juan Chen
Law school, University of New South Wales
Sydney, Australia
chenzhuojuan@gmail.com

Abstract: This paper scrutinizes the application of mandatory bid rule in China. It argues the rule has been ineffective in practice and provides distorted treatment among shareholders. It further explains the reason is because the deterrent effects of this rule in China’ s context. As for a solution, the paper proposes an equitable treatment rule.

***Keywords: mandatory bid rule; the equal treatment of shareholders; the equitable treatment of shareholders*[1]**

I. INTRODUCTION

China adopts a mandatory bid rule (MBR) in its takeover law. It mandates an acquirer, after obtaining 30% or more voting rights in a public listed company, to make an offer for to all the shareholders on a pro-rata basis. The minimum offer price is the highest price paid in the last six months. The bid is required to remain open between 30 and 60 days. When the bidder changes the offer, the new offer applies retroactively to shareholders that already tender their shares.[2]

This paper scrutinizes the practical effects of this rule in the Chinese context. It starts from the rationale of MBR in general, and then reviews the application practice. The paper proceeds to explore the reasons for the failures. It concludes by proposing a shift into the equitable treatment.

II. RATIONALES OF THE EQUAL TREATMENT OF SHAREHOLDERS

The equal treatment of shareholders is the underpinning principle of MBR. Specific requirements listed above are all centered at preserving an equal treatment among shareholders within the same class. The minimum price rule and the retroactive application are both aiming at preserving the equality of share prices. The minimum offer period also ensures a reasonable time for shareholders to consider the merits of the offer. In addition, the equality objective for a tender offer is self-evident. A most influential argument for MBR is ‘the vulnerability of minority’[3]. It is argued that the change of control constitutes a major incident that has significant influence on shareholders’ interests. But due to their inferior voting power, the minorities are often deprived of the opportunity of participation and proportionate sharing. The existing controller may preclude the minorities from participating and reap the premium all by himself. Also, the acquirer may prefer to acquire shares from block shareholders when considering the transaction cost or the closeness of ownership. Therefore, the change of control may happen without the notice of minority shareholders. In addition, minorities may be left with insufficient time or information to evaluate the offers. They may also be directly or indirectly forced to accept some unequal offers.

The second inspiring argument is that MBR deters looting. As thoroughly discussed by the designer of MBR,[4] if the looter makes a full bid and takes up all the shareholdings, it will be pointless to loot. If the acquirer does not take all the shareholdings, the existing controller will have some remaining stakes along with the minorities under the operation of MBR. This will give the existing controller incentives to investigate and evaluate the potential buyer with more cares. From a different yet coinciding perspective, when the acquirer is mainly motivated by looting, he will face substantial barriers under MBR. The seller will not agree for a partial sale due to the potential risks. But a full sale by the controller will make the transaction least appealing to the bidder. As discussed above, it is pointless to loot a company where the looters own all the shareholdings. In fact, the looter will be unwilling to take more shares other than the barely control block. [5]

These arguments need to be further scrutinized. To start with, the vulnerability of shareholders is clearly an important consideration. It is therefore justifiable for the law to provide some advantageous arrangements. However, the vulnerability proposition fails to consider the proportionality between corrective rules and potential risks. It is possible that shareholders have been better off with the developments of company law and securities regulation since 1960s. Especially, with the extensive rules on disclosure and director’s duty, it is unreasonable to comprehend the same level of minority appropriation as in the old times. Even if protection is still highly necessary, it remains to be proven that MBR is a suitable rule. The law could safeguard the interests of minorities by indirectly regulating the

[1] The author is very grateful for all the inspiring comments from Professor Dimity Kingsford Smith in the early discussions of this paper. The usual disclaimer applies.

[2] Measures for the Administration of the Takeover of Listed Companies promulgated by CSRC on 2006-07-31 (China Securities Regulatory Commission ed., 2006)., article 24,25,26,27,35,56.

[3] There are some less influential and to this author, less covincing arguments such as the involuntary financing by minorities, or control as a corporate asset, or the coherence with corporate law principle. ADOLPH BERLE, Control in Corporate Law, 58 Columbia Law Review (1958). ROLF SKOG, Does Sweden Need a Mandatory Bid Rule? (SUERF. 1997).

[4] The equal treatment rule is often perceived as originating from the British City Code, which comes into force in 1968. To the knowledge of this article, American scholar William D. Andrews is the first author who brings up and thoroughly discusses the equal treatment rule. See WILLIAM D. ANDREWS, The Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 Harvard Law Review (1965).

[5] There are some other plausible arguments such as , ‘public shareholders may invulnerably finance the bid’, or ‘control is a corporate asset’, or ‘shareholder protection enhances the development of capital market’are either too farfetched or insufficient to justify the MBR.

management or the existing controller. In a word, the vulnerability argument is important, but it is not sufficient to justify the equality rule by this proposition alone.

The deterrence of looting has the potential of becoming the kernel of truth. A good regulation encourages the value-enhancing transactions and discourages the value-decreasing transactions. Professor Andrews has convincingly illustrated how MBR deters looters. He also argues that valueenhancing takeovers will not be barred under MBR. According to him, if the buyer does not aim at looting, he will be indifferent to a larger shareholding. His gains will increase proportionately under a larger share ownership. Also, the existing controller and the minorities will not object to continue some of their investment, with the hope of sharing the positive future. [6]If all these propositions are testified, MBR will be an ideal rule which automatically screens the value-enhancing takeovers from lootings. It naturally diminishes lootings without discouraging value-enhancing takeovers. The benefits should be considered together with the avoidance of perplexities in proving harms in lootings, and the reduction of uncertainty of legal rules.

However, the argument that MBR has nondeterrence on value-enhancing takeovers has been furiously attacked by following researches. The opponents consider it is against the politic of corporation for the existing controller to continue a substantial amount of investment together with the new controller. Neither the seller nor the buyer will find it appealing to have a parallel block. Although professor Andrews argued financing may not be a primary barrier for MBR, the dissenting opinions hold the buyer may be unwilling to purchase all the shares due to other considerations such as diversification. More importantly, as will be illustrated in China's context,[7] MBR can impose significant deterrence in certain circumstances.

III. EQUALITY IN A QUANDARY

Lengthy provisions on MBR have been largely annulled by practice. From 2003 to 2007, there are more than 2,500 takeovers in China's capital market. However, there are only 28 tender offers. Except the 7 mandatory full bids, only one offers a premium to the target shareholders. It could be concluded MBR largely fails to safeguard the right of minority shareholder in sharing the control premium.

Worse still, relevant provisions and their limited applications provide distorted treatment favoring the controlling shareholder and state shareholder. Instead of protecting minorities, it exaggerates the oppression against minority shareholders. The legislature, implementing agency and market participants all 'contribute' to the failure of MBR. The legislature provides a number of exemptions. Some of them are justifiable. Nonetheless, two sets of contentious exemptions are worthy of close examination. One is that the gratuitous share transfers among state-owned assets are generally exempted from making a mandatory bid. The other is that the acquisition by existing controller to consolidate control will probably be exempted from making a mandatory bid.[8] Also, it should be noticed that he implementing agency — China Securities Regulatory Commission (CSRC) enjoys unfettered authorities in exemptions.[9] As illustrated by the data in last paragraph, such discretion is exercised rather loosely in practice.

The acquirers who fail to obtain official clearance often successfully escape from the mandatory obligation through 'creative' compliance. One common tactic is to provide a discounted price to minority shareholders. The rationale of such strategy should be comprehended with features in China's stock market. Before the reform of segregated shareholdings in 2005, the controlling blocks in China's public listed companies were usually comprised of non-tradable shares and subject to a separate pricing system.[10] The price of non-tradable share was based on the net asset value, in contrast with the stock-market based price for tradable shares. Conceivably, the latter was usually several times higher than the former. Because the non-tradable shares were cheaper and usually represented a large block, they were more appealing to the acquirer. Also, public listed companies in China enjoy

noticeable advantages in areas such as financing and public profiles. Therefore, the bidder always tries to keep the public shareholding above the minimum standard required by listing rules. As a consequence, bidders in China offered some premium, but the premium was calculated to only solicit the nontradable shares. For public investors holding tradable shares, the offer represented a discount with the aim of discouraging them from tendering. [11] The share segregation reform eliminates the barriers between segregation of tradable and non-tradable shares. The current code also amends the minimum price requirement from 90% to 100%. These changes bring some 'real' tender offers with positive premium for public shareholders. Nonetheless it is still common to see that the price is set up around the minimum standard, which is in fact a discount to the market

6 William D. Andrews, above n 4, p 526-530.

7 See Part II.B.2. and Part III.A.

8 The takeover law, article 62(3), article 61 (1), (3).

9 Considering the contingency of takeover transactions, it is desirable to leave discretion to the implementing agency. Nonetheless, in prominent jurisdictions, such discretions are usually constrained by substantial and procedural rules. Take Australia as an example. Australian Securities & Investments Commission (ASIC) has the authority to exempt or modify relevant rules. However, ASIC is required to act under the prescribed purpose of takeover regulation. It has to publish its decisions in Gazette, and also to notify the decision and review right to relevant parties. In addition, the administrative decision made by ASIC is subject to the review of Takeover Panel, a peer review body comprised of professionals. See Corporations Act 2001(Cth) s 655A,655B,656A. However in China, the constrains are largely missing and the results of administrative discretions become less predictable.

10 Because these shares can not be traded in the secondatory market, therefore the price for non-tradable shares is often inferior to the tradable shares.

11 The tactic is very feasible because the former code provided the minimum price for the tradable shares is only 90% of the market price. For an application of this strategy, see the first mandatory bid — the NanGang Gufen case. The price for tradable shares is exactly the minimum prescribed price, represent a 19% discount to the market price on the announcement day. The price for the nontradable share is in contrast represent a 10% premium to the market price.

price.[12] One possible explanation is that the bidder can secure a working control without acquiring more shares. For example, the bidder may stop at the 29.9% shareholding. This is actually another strategy for creative compliance.[13] A 29.9% shareholding may not be different from 30% in terms of effective control. Presumably, many of the 29.9% shareholders will purse de facto control through some indirect ways.

To make the situation even worse, the equality among shareholders deteriorates with the implementation of MBR. When the controlling shareholder acquires asset from the company, the average asset appreciation ratio is 10.57%. When it sell asset to the company, the appreciation ration is the sky-high 132.48% in average.[14] In other words, the acquisition by controller provides favorable treatment for himself.

Theoretical explanation for the above abnormal is that MBR may have chilling effects in China's concentrated shareholding structure and the unsatisfactory level of market integrity. When there is an existing controlling block, the transaction cannot happen if the block holder is unwilling to sell. However according to MBR, the minorities equally participate in the control transaction and share the premium with the controller. It in essence requires the current block holder to forgo the benefits it held before the transaction. When the existing benefits are greater than the proportionate gains in a proposed takeover, the controller may be unwilling to sell. Additionally, the acquirer is also discouraged because he has to distribute some gains to the minority shareholders.[15] A major motivation for takeovers in China is to further secure control and amplify the private gains.[16] Such private benefits are not difficult to be comprehended when considering the developing and transitional status of China's capital market. It should be mentioned private gains are not always illegitimate. For example, they may arise from the power to implement the controller's business strategy. However when private benefits are real, the deterrent effect of MBR exaggerates. Suppose the controller's shareholding is 40%, and the aggregate corporate value is 100. The controller could extract a private gain valued at 20. The interests held by controller before the bid was 60. An acquirer approaches the controller and promises to enhance the aggregate corporate value into 130. In order to make the proposal more attractive, he promises to keep the controller's shareholding intact and only acquire shares from minority shareholders. Under the proposal, the existing controller would still hold 40% shares afterwards, but the private gains would be eliminated. The proposal may sound favorable both to the company and to the existing controller. But the controller may still turn down the proposal, because the interests held by him would be reduced to 52.

The deterrence effects of MBR help understand the abnormal of China's MBR. The legislature, fearing the cost on efficiency, provides a range of safe harbors which largely annul the rule. The acquirer, facing the concentrated shareholding structure of the target, feels the rule least attractive, and tries every means to circumvent the obligation. In the end, the existing controlling shareholder becomes the biggest winner. It can block an unwanted bid to secure its illegitimate gains, or to consolidate control without offering a premium to all the other shareholders.

IV. REGULATORY GOALS IN PROPOSITION

As discussed above, absolute equality is not a suitable in China's shareholding structure and status of development. As an alternative, the article argues China should adopt an equitable treatment rule.

Equitable treatment firstly differentiates the concentrated shareholding from dispersed shareholding. MBR is a sound policy in dispersed shareholding structures. It protects the integrity and investors' confidence in the market, and consequently increases accesses to fund. It does not cause material loss either. As there is no existing controller, nobody is required to forgo his existing interests. Neither is the potential acquirer discouraged. Whether the rule is in place or not, the acquirer has to obtain control from dispersed shareholders. However as well illustrated above, when there is a controlling block, most of the undesirability becomes material. To reconcile, an equitable treatment rule requires equality in tender offer and on-market purchases. But in the private sale of control, it requires fair, rather than equal treatment. When the existing controller reaches an agreement with the acquirer to transfer his controlling block at a premium, he is not required to share such premium with others.

Secondly, the equitable treatment implies a more comprehensive approach to safeguard the interests of shareholders. To start with, equitable treatment could be safeguarded by substantial rules. Such rules set up minimum standards to protect vulnerable groups who do not have sufficient capacity to protect themselves under pure market mechanism.[17] As an illustration, Professor Daniel Fischel suggests that in the sale of control, the minimum price should be safeguarded by law. The author further suggests the minimum price for minority shares should the prebid price.[18] Also, procedural rules are crucially important in

[12] Ronggen Ge, Pexin Group Bid for Zhongke Hechen at Discounted Price, Shanghai Securities News 2008-12-24. 2008.

[13] Ning Hao, Hualian Group Stops at the 'Mandatory Bid Threshold' and Turns to Real Property Development through Corporate Reorganization China Securities Journal 2009-06-22. 2009.

[14] Annual Report on Asset Appraisal of Public Listed Company Takeovers (2009).

[15] For the deterrence effects of takeovers in general, see LUCIAN A. BEBCHUK, Efficient and Inefficient Sales of Corporate Control, 109 The Quarterly Journal of Economics (1994). The author further proposes some innovations to mediate the deterrent effect. For example, the author suggests freeze out and two-tier acquisition can produce incentives for the exsiting controller. The controlling shareholder could buy shares from the minority shareholder at a lower price, and resell it at a higher price to the acquirer.

[16] Xianguo Yao, et al., Motivations for Corporate Governance and Takeovers, in China Securities Year Book (Editing Commission ed. 2003).

[17] But legal intervention shall not exceed the necessary boundary. Otherwise it becomes another form of oppression.

[18] DANIEL R. FISCHEL, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 Texas Law Review (1978).

achieving an equitable treatment. Substantial rules cannot be always determined by the legislature ex ante. Some may only become available ex post. Others may vary with specific context. For example, how could the legislature know for sure that shareholders prefer an equal treatment with greatly reduced takeover occurrences? Will they prefer an equitable treatment plus increased returns under the improved management? It may be arbitrary to vote for either side. As an alternative approach, the legislature may turn to preserve the impartial and open procedures. For example, it may mandate the mandatory disclosure on a real time basis, or an appraisal right for minority shareholder, or the court's supervision in corporate reorganization. Under such legal infrastructures, the relevant parties can bargain over the available options and reach a conclusion. Also, when disputes arise or when consensus is not able to be achieved, there are procedures available to make a decision and solve the disputes.

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