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DEFENSE MECHANISMS AGAINST HOSTILE TAKEOVERS (COMPARATIVE ANALYZE)

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ABSTRACT

Profitable businesses are always at risk of becoming prey for others. At the same time, corporations are often taken over by competitors. In such circumstances, methods of protection against unfair takeovers are more important than ever. This article compares the concept of hostile takeovers and the types of mechanisms to combat it on the example of several states practice. The hostile takeovers appear to be the most complex and vital topic in corporate law. This article may be helpful with simplifying the main points and comparing hostile takeover defenses.

Keywords: *hostile takeover, merger, acquisition, "poison pill", white night, proxy contest.*

АННОТАЦИЯ

Прибыльные предприятия всегда рискуют стать добычей других. В то же время корпорации часто поглощаются конкурентами. В таких условиях как никогда важны методы защиты от недобросовестных поглощений. В данной статье сравнивается понятие враждебного поглощения и виды механизмов борьбы с ним на примере практики ряда государств. Враждебные поглощения представляются самой сложной и актуальной темой в корпоративном праве. Эта статья может быть полезна для упрощения основных моментов и сравнения средств защиты от враждебного поглощения.

Ключевые слова: *недружественное поглощение, слияние, поглощение, «таблетка яда», белая ночь, конкурс доверенностей.*

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INTRODUCTION

A company can restructure in multiple ways, such as a merger or acquisition. A merger occurs when two companies combine and create a new entity.[1] An acquisition occurs when the target company continues to operate but operates under the acquiring firm.[2] Acquisitions can be friendly or hostile. A friendly acquisition happens when the board of directors (the "board") agrees and recommends to the shareholders to accept the acquisition. However, a hostile acquisition occurs when the board of the target company is unaware or opposed to the acquisition. The reasons a company may want to merge or acquire another company include to increase shareholder wealth, diversification, or to acquire assets.[3] A company may want to reach a new market or cut costs by acquiring companies in the line of production. However, the board may think the merger will hurt the company and want to stop it from happening. Depending on the country, the target's board may use defense mechanisms to prevent hostile takeovers.

The board must do what is best for the shareholders. The merger or acquisition may not be in the best interest of the company. So, defense mechanisms give the board a way to fight or prevent hostile takeovers. Some defense mechanisms include poison pills, white knight, and staggered boards.

The poison pill defense mechanism is a shareholder rights plan which allows shareholders to buy shares at a discounted price if certain events occur.[4] The purpose is to protect shareholders from the bidder forcing a merger or acquisition. Poison pills aim to prevent tender offers because the pill goes into effect once the bidder acquires a certain number of shares. In a tender offer, the bidder will usually offer a premium to the shareholders to gain a controlling amount of voting shares. If the pill goes into effect it may be very costly for the bidder. Therefore, the poison pill will be a deterrent to the bidder.

There are many varieties of poison pills that will determine exactly how the pill works. Generally, the event that triggers the pill is a merger or acquisition. However, some of the pills may be redeemed if the board considers the acquisition good for the company. One example of a pill is a "back-end" poison pill plan. This pill is triggered when the bidding company forces the target company to merge with it.

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[1] Brent Hammack, A Comparative Analysis of U.S. & U.K. Regulations Pertaining to Domestic Corporate Takeovers, and the Resulting Differences in Hostile Takeover Activities Between the Two Markets, 25 Willamette J. Int'l L. & Disp. Resol. 121, 122(2018)

[2] Id.

[3] Motives for Mergers. CFI. https://corporatefinanceinstitute.com/resources/knowledge/deals/motives-for-mergers/

[4] § 23:7.Judicial treatment of specific types of defensive maneuvers, 4 Treatise on the Law of Corporations § 23:7 (3d)

When the pill is triggered the shareholders will be able to buy the bidding company's shares at a substantially discounted price. The pill will cause the dilution of the bidding company's shares. This will be a disincentive for unwanted bidders because it will make it very costly for the bidder to acquire the target company without board approval.

However, the way around the back-end poison pill is for the bidding company to allow the target company to operate as a subsidiary instead of forcing a merger. Another way to get around a poison pill is for the bidding company to convince the board to redeem the pill. There are many more types of poison pills that work in other ways.

DISCUSSION AND RESULTS

Sometimes, along with a poison pill, a company will also have a staggered board. A staggered board occurs when members of the board are elected in different years, instead of all at once.

This will help deter a proxy contest to acquire the company. A proxy contest occurs when the bidding company tries to convince the shareholders of the target company to elect new members of the target company's board. The new members will then agree to the merger or acquisition. However, if there is a staggered board it becomes much more difficult to replace enough board members quickly to approve the acquisition or merger. This can be used alone orwith other defense mechanisms.

If no defense mechanisms can prevent the takeover but the board does not approve of the bidding company, the board may look for a white knight. The board will look for a more preferable third party to merge with instead of the bidder. This is an option to find a better suitor for the target company than the current bidder. Usually, the white knight will keep the board of the target company and there will be friendlier negotiations. However, there are challenges with this approach. The bidding company has had ample time to review the target company and decide the takeover is worthwhile. The board will have to decide on a white knight quickly to avoid being taken over by the bidder. This may not allow enough time for the board to fully comprehend all the potential consequences of the merger or acquisition by the white knight.[5] However, the board could determine this is the best option to take.

Defense mechanisms differ between countries. This paper will begin with a brief overview of the laws governing takeovers in the United States (the "US") and the European Union (the "EU"). Looking more specifically United Kingdom (the

[5] § 10:73. Defensive mergers—Economic dangers, Corporate Acquisitions § 10:73 (2020)

"UK") and France within the EU. Then this paper will examine which defense mechanisms are allowed and the standard of review of the board's decisions will be scrutinized by the relevant supervising body.

The US

Generally, in the US corporations are governed by state law. Each state may create its corporate laws. The state corporate laws will govern the board and directors' decisions.

However, state laws cannot conflict with the federal laws that apply. Federally, the Securities Act of 1933 (the "33 Act") was created to regulate disclosures when a company does an initial public offering of securities. The Securities Act of 1934 (the "34 Act") was created to regulate the secondary exchange of securities. Further, the Securities and Exchange Commission (the "SEC") was created by the 34 Act to monitor the securities exchange in the US. Additionally, the Williams Act Amendment of 1968 (the "Williams Act") amended the 34 Act to protect shareholders from unforeseeable, coercive tender offer threats. The Williams Act included mandatory minimum timeframes for the tender offers to stay open, disclosures to shareholders, and price protection for shareholders.

This paper will focus on Delaware's General Corporate Law (the "DGCL") because Delaware is the favorite state for corporations to incorporate in. Further, the case law in Delaware is very influential to other states as well. Under the DGCL and the case law, directors of a company have a duty to act with loyalty and care. Directors must make decisions in good faith and on an informed basis. While making decisions, directors will have to make judgment calls. Therefore, the Court of Delaware has provided for the business judgment rule for directors' decisions. The business judgment rule is a presumption that directors made a decision on an informed basis and in good faith.[6] When considering a takeover, the board must do what is in the best interest of the shareholders. However, there may be conflicts of interest because the board will not want to be replaced if the company is taken over or may have other self-serving interests. When reviewing takeover defense mechanisms courts will apply the Unocal heightened review before applying the business judgment rule. Under this standard, the board must show that there was a reasonably perceived threat, and the response was reasonable.[7]

In the US, a common defense mechanism used by the board of a target company is a poison pill. The board may have the option to redeem the pill to avoid

[6] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985), overruled by Gantler v. Stephens, 965 A.2d 695 (Del. 2009)
[7] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)

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the effects from happening. Therefore, the board will have to decide whether to redeem the pill or to allow the effects to take place. This is where litigation will occur questioning the business judgment of the board. The Unocal enhanced scrutiny will be used by the courts.

In the US, the defense mechanism of a white knight is also used. Sometimes, the target company will enter a lock-up agreement with the white knight. This is a type of poison pill that will lock-up the assets or shares exclusively for the white knight which are agreed upon in the lock-up agreement. This will make the company less attractive to bidders. However, the board has a duty to make informed decisions. The board will have to determine if the white knight is better for the company than the bidder. Under Delaware law, lock-up agreements are not per se illegal. Lock-up agreements can promote more bidders for the company. However, when it is inevitable that the company will be sold, the board must try to get the highest price for the shareholders.[8] In the Revlon case, the board authorized the management to negotiate a merger. This signaled that the company was going to sell, and the board knew it. The duty of the board then shifted to gather enough information to make the most money for the shareholders. Other considerations, potential lawsuits from noteholders, were not as important as the value for the shareholders. In Revlon, the board breached their fiduciary duty of care because they did not understand all the implications of selling to the white knight. It was not as profitable for the shareholders for entering a lockup provision with the white knight as opposed to selling to thebidder.

Overall, many defense mechanisms are allowed to be taken by the target board. However, the board must be adhering to their duties of loyalty and care. Further, the threat must be reasonably perceived, and the response must be reasonable.

The EU

The European Union (the “EU”) has the power to hand down directives in which the member states must transpose the principles from the directives into their national law.

Directives are a way to harmonize the EU laws to ensure that certain general principles apply all over the EU. The EU decided to hand down a directive regarding takeover bids to harmonize member state laws. The Directive on Takeover Bids 2004/25/EC[9] requires member states to give certain protections to shareholders, such

[8] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)
[9] Takeover Bids Directive 2004/25/EC. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32004L0025&from=EN

as equivalent treatment within the same class, time and information needed to reach an informed decision. Further, the board cannot deny the shareholders the opportunity to decide on the bid based on the merits. To enforce the rules each member state must have supervisory authority. This forced every member state to create an authority that could regulate takeover bids and enforce the principles of the directive. The principles are enforced on a national level, so by individual member state authorities.

The UK

In the UK, takeover oversight started with self-regulation in 1968.[10] The governor of the Bank of England invited financiers and investors to form a committee after the first hostile takeover attempt in England. This committee created guidance to safeguard shareholders' interests during takeovers. Later in 1968, the committee met again and created the City Code on Takeovers and Mergers (the "Code"). In addition to the Code, the committee created the Panel on Takeovers and Mergers (the "Panel") which was a body with the authority to enforce the Code. The Code and Panel remained self-regulatory until 2006 when the UK implemented the Takeover Directive. Self-regulation worked for so long because of the connections that companies needed to maintain. The Bank of England was at the creation of the code and it involved other banks as well. If a company wanted to keep financing options open it would be easier to have a good reputation with the banks.

In 2006, the UK transposed the Takeover Directive, so the self-regulatory scheme was put into legislation in the Companies Act. The Panel has up to 36 members and is divided into two sections: the hearings committee and the code committee.[11] The hearings committee reviews the executive's decisions, and the code committee makes the rules. The Panel executive handles the day-to-day work. The Panel executive can conduct investigations, monitor actions that fall within the Code, and give the Code's interpretation, application, or effect. The Panel executive can act initiate or a third party can request action.

The Code requires the board to follow the non-frustration rule. Rule 21.1 of the Code states "during the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be

[10] Brent Hammack, A Comparative Analysis of U.S. & U.K. Regulations Pertaining to Domestic Corporate Takeovers, and the Resulting Differences in Hostile Takeover Activities Between the Two Markets, 25 Willamette J. Int'l L. & Disp. Resol. 121, 122(2018)
[11] The Takeover Panel. https://www.thetakeoverpanel.org.uk/structure

imminent, 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 merits…" [12] Further, boards are not allowed to "(i) issue any shares or transfer or sell, or agree to transfer or sell, any shares out of treasury or effect any redemption or purchase by the company of its own shares; (ii) issue or grant options in respect of any unissued shares; (iii) create or issue, or permit the creation or issue of, any securities carrying rights of conversion into or subscription for shares; (iv) sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount; or (v) enter into contracts otherwise than in the ordinary course of business."[13] This limits the options boards have when they receive an offer or may believe that there may be an offer soon without shareholder approval. Under rule 21(b) the company must consult the Panel if there is any doubt if the action the board will take falls under the prohibited acts in rule 21(a). Further, the Panel can disapply rule 21(a) under certain circumstances listed in rule 21(c).

To use a strategy prohibited by rule 12(a) with shareholder approval the board must also fulfill three other requirements. First, the target company's board must get financial advice about if the acts are fair and reasonable. Second, the board must tell the Panel the date of the general meeting. Third, the board must send out specific information to the shareholders.[14]

Poison pills are generally not used in the UK. They are not favored practices.[15] Further, shareholders must approve the use of any poison pill because it would involve at least one of the events prohibited in Rule 21(a). On top of the shareholders' approval, the board will also have to go through the additional steps before the general shareholder meeting. Or the board will have to apply to the Panel to fall within one of the exceptions for the Panel to disapply rule 21(a). In the UK, the decision for merger or acquisition mainly rests in the hands of the shareholders.

Staggered boards do not have any defensive effect against hostile takeovers in the UK. A company can set up a staggered board in its charter. However, under Article 168 of the Companies Act, a director can be removed by an ordinary resolution.[16] This removal can be done regardless of any agreement made between

[12] Takeover Code Rule 12.1(a)
[13] Rule 12.1(a)(i)-(v)
[14] Takeover Code Rule 21(d)(i)-(iii)
[15] Dual Listed Company Transactions and Frustrating Action. The Panel on Takeovers and Mergers. PCP 11. 26 Apr. 2002.https://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/pcp11.pdf
[16] 2006 Companies Act Article 168(1)

the company and the director. Also, the director can be removed before their term expires. Therefore, it is not possible to have a powerful staggered board to try to delay a hostile takeover.

One defense the board can pursue without shareholder approval is a white knight. Rule 31.1 of the Code requires offers to be open for a minimum of twenty-one days.[17] This gives the board time to find and receive offers from third parties. This is allowed because it promotes competing bids. This will be good for shareholders because it will allow the shareholders to get the best possible deal if there two companies are competing for the target company.

Japan

According to Japanese Law, mergers and acquisitions are regulated by the Commercial Code, as well as, also subject to control by other laws such the Anti-Monopoly Law. Two types of mergers are provided by Japan Commercial Code. They are merger by absorption (in this case, one company absorbs another) and merger by incorporation (both merging companies cease to exist and a new company is set up). The former one is common method used in Japan. In order to merge, companies must conclude an agreement of merger, subject to approval at the shareholders' meeting of each company (Art. 408, para.) At the shareholders' meeting, the shares held by the shareholders present exceed half of the issued shares, and the resolution must be approved by more than two-thirds of the voting shares (Art. 408, para).

Hostile takeovers of a company are rare in Japan. The system of tender offer (takeover bids) was introduced in Japan in 1971, but until 1990 there were only three take-over bids. In 1997 there were four take-over bids involving listed companies.[17]

Hostile acquisition of a company may take place by purchasing shares either through the stock market or off market. However, since the great majority of companies are closed companies, this can be very difficult. Shares of listed companies are freely transferable, but due to the existence of stable shareholders it is also difficult to acquire significant shareholdings in these companies. At one stage investors purchased convertible bonds and warrant bonds issued abroad for such purposes.[18] A shareholder with more than 5 per cent of the issued shares of a company must file a report with the Minister of Finance.

As a defense against an imminent take-over, some companies have issued new shares and allocated them to a friendly partner, thus diluting the shares the raider has

[17] Zoshi-hakusho, supra, pp. 152-153.
[18] K.Ishizumi, *Acquiring Japanese Companies*, Tokyo 1988, pp. 151-184

collected. However, issuing new shares solely for the purpose of fending off raiders is considered to be unlawful.

In Japanese Company law, poison pills method is also allowed in order to take action against hostile take-over. According to Article 408-3 of the Commercial Code, shareholders opposed to the merger are entitled to require the company to purchase their shares at a fair price which the share would have been worth had the merger not taken place. Shareholders must inform the company of their intention and actually oppose the merger at the shareholders' meeting.

The Republic of Uzbekistan

As formation of a basis of company governance in our nation has begun with establishing company legislation, initial of all, with enacting necessary laws control the company relations, Uzbek corporate governance is based totally on civil law that forms main legal rules with reference to company governance. So, in Uzbekistan mergers and acquisitions are regulated by the Civil Code, as well as, also subject to control by other laws such the Anti-Monopoly Law, Law on Joint-Stock Companies and Protection of Shareholders` Rights, Law on restricted and extra Liability firms, Law on Business Partnerships and others.

In the Republic of Uzbekistan, a common defense mechanism used by the board of a target company, similar to US, is a poison pill. According to Law on joint stock companies and protection of shareholders' rights

If the number of shareholders does not exceed fifty, the charter of the company may provide for a preemptive right:

from shareholders for the acquisition of shares sold by other shareholders of this company, at a price and on the terms of an offer to a third party in proportion to the number of shares owned by each of them;

from a company for the acquisition of shares sold by its shareholders, if other shareholders of this company have not used their preemptive right.

A shareholder selling his/her shares is obliged to notify in writing directly or through the company of the remaining shareholders of his/her intention to sell his/her shares, indicating the price and terms of the offer to a third party.

The procedure and terms for exercising the pre-emptive right to purchase shares sold by shareholders are established by the charter of the company, while the term for using the pre-emptive right cannot be less than ten or more than thirty days from the time the shares are offered for sale.

In the event a shareholder sells shares owned by him/her in violation of the preemptive right, any shareholder of the company and (or) the company shall have the right within three months from the moment when the shareholder or company knew or should have known about such a violation, demand judicial transfer of rights to them and buyer's responsibilities.

Assignment of this preemptive right to acquire shares is not allowed.

There is another practice in Uzbekistan to combat hostile takeover, although it seems that the mechanism of its implementation is a bit complicated. It is emphasized that in the management of corporations, along with the governing bodies, their founders should act only in the interests of the legal entity. This is understood from the essence of a number of principles of corporate governance. Corporate law states that the fiduciary duties of the director and stakeholders of the corporation, in general, consist of the duties of due care, loyalty and duty of good faith.[19]

Uzbek Corporate Governance Principles set out the principal's two fiduciary obligations. In other words, the director must perform his duties in similar cases from the point of view of a reasonable person, taking care of the interests of the company in the most appropriate way (duty of due care). The obligation to be loyal to the company requires the director to give priority to the interests of the company in its own interests or the interests of third parties in concluding a contract with the company, and to notify the company of the transaction in which it is interested[20].

Comparison

The US allows many types of defense mechanisms while they are strictly regulated in the UK. The US allows poison pills, staggered boards, and white knights. However, the UK only allows for white knights. Both regulatory systems developed differently and have a different system of regulation. In the US, state law governs the directors' actions with federal law overseeing takeover regulations. In the UK, the 2006 Companies Act regulates directors' actions, and the Takeover Code governs takeovers. Enforcement in the US is by the courts and in the UK by the Panel. The main decision of the takeover is in the hands of the directors for hostile takeovers in the US because of all the options the board must fight off the bidder. However, in the UK, the power is in the shareholders' hands because of the

[19] Ibrohimov, A. A. O., Koryogdiyev, B. U. O., & Tojiboyev, S. Z. (2022). KORPORATIV NIQOBLARNI OLIB TASHLASH KONSEPSIYASI VA UNI O'ZBEKISTON KORPORATIV HUQUQIDA TAKOMILLASHTIRISH MASALALARI. *Oriental renaissance: Innovative, educational, natural and social sciences*, *2*(1), 1068-1082.

[20] Imomniyozov, D. B. O. (2021). KORPORATSIYA IJRO ORGANLARINING FIDUTSIAR MAJBURIYATLARI QIYOSIY HUQUQIY TAHLILI. *Oriental renaissance: Innovative, educational, natural and social sciences*, *1*(11), 588-600.

regulation against defensive measures in the Code. The thing both jurisdictions have in common is to maximize shareholder profit. In Japan, one of the leading countries in Asia, various methods are used to combat against unfairly merge legal entities. Unlike in US, the poison pill method is not widely used in Japan. Relationships in this area are regulated by both the Commercial Code and a number of regulations. When studying the practice in Central Asia on the example of the state of Uzbekistan, it can be seen that the country's legislation allows only the poison pill method to prevent unfair merger of corporations. The regulation of such relations, as in Japan, is governed by the Civil Code and by-laws.

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