Lothar Krumpen

The case for a balanced regulatory approach to board neutrality during a tender offer in New Zealand: A comparative analysis of takeover defences in Delaware, Germany and New Zealand

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Faculty of Law
Victoria University of Wellington

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Abstract

In New Zealand, a strict board neutrality rule currently prohibits any action of the board of directors that could effectively result in a tender offer being frustrated. Due to COVID-19, some corporations are especially vulnerable today to a hostile takeover at deflated prices. While corporations in the United States were able to swiftly react to the impact of COVID-19 by introducing takeover defences, New Zealand corporations were unable to implement such defensive measures. This paper analyses the regulatory approaches in Delaware, Germany and New Zealand to the most potent takeover defences (poison pills, equity restructuring, acquisitions and disposals and staggered boards) to provide a framework for regulatory reform in New Zealand towards a nuanced board neutrality rule. The recommended framework includes a board neutrality rule (similar to the board neutrality rule in Germany), which allows for independent directors to approve the use of takeover defences, provided that these defences are not otherwise prohibited, and for ex-ante shareholder approval of takeover defences for a maximum term of 18 months. The case for a balanced regulatory approach to board neutrality during a tender offer is supported by new empirical evidence that documents value-creating effects as a result of utilising takeover defences, the impact of COVID-19 and persuasive arguments in favour of a nuanced board neutrality rule.

Keywords

board neutrality rule, tender offers, takeover defences, Delaware, Germany, New Zealand

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I Introduction

Lord Denning's well-known statement "Quis custodiet ipsos custodes – Who will guard the guards themselves?" epitomises a fundamental tension in corporate law and governance, that is, the conflict of interest between shareholders and the management of a corporation.[1] Hostile takeovers, specifically the use of offers to purchase shares directly from the shareholders of the target[2] in order to *bypass* the resistant board of directors (**tender offers**), became a regular mode of acquisition in the United Kingdom and the United States during the 1980s.[3]

In New Zealand, a strict board neutrality rule currently prohibits any action of the board of directors (the **board**) that could effectively result in a tender offer being frustrated.[4] In light of the new empirical evidence that documents value-creating effects as a result of utilising takeover defences, the impact of COVID-19 and the persuasive arguments in favour of a nuanced board neutrality rule,[5] New Zealand should abandon its strict board neutrality rule. This paper analyses the regulatory approaches in Delaware and Germany in respect of takeover defences to provide a framework for regulatory reform in New Zealand towards a nuanced board neutrality rule. Delaware has no board neutrality rule in place and the use of takeover defences is largely unrestricted.[6] In Germany, the use of takeover defences is restricted by a nuanced board neutrality rule and comprehensive rules in the Stock Corporation Act.[7]

Today, a significant proportion of all takeovers remains hostile (i.e. contested by the target firm's board), such as Xerox's attempted takeover of HP, which Xerox abandoned because of the COVID-19 pandemic, and Broadcom's attempted takeover of Qualcomm at the end of 2017, which was blocked by an order of United States President Donald Trump.[8] Due to depressed valuations as a result of COVID-19,

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[1] *Norwest Holst Ltd v Secretary of State for Trade* [1978] Ch 201 (CA) at 223 per Lord Denning MR; Reinier Kraakman and others *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd ed, Oxford University Press, Oxford, 2017) at 2 and 29; and Luca Enriques and Paolo Volpin "Corporate Governance Reforms in Continental Europe" (2007) 21 Journal of Economic Perspectives 117 at 117.

[2] "Target" means the corporation subject to the tender offer.

[3] Mike Burkart and Fausto Panunzi "Takeovers" in Xavier Freixas, Philipp Hartmann and Colin Mayer (eds) *Handbook of European Financial Markets and Institutions* (Oxford University Press, Oxford, 2008) 265 at 265.

[4] See section V(B)(2).

[5] See section II.

[6] See section III.

[7] See section IV.

[8] Martin C Glass and Oleksandr Polonyk Market Trends 2018/19: Hostile Takeovers and Proxy Contests (LexisNexis Practice-Advisor, Practice Note by Jenner & Block LLP, 2019) at 2 and 3, noting that hostile

corporations are especially vulnerable today to a hostile takeover at deflated prices.[9] Corporations in the United States were able to swiftly react to the impact of COVID-19 by introducing takeover defences, which is demonstrated by the fact that at least 73 corporations have announced the adoption of a poison pill[10] between March and June 2020.[11] Meanwhile, the absolute prohibition on takeover defences in New Zealand leaves corporations vulnerable to hostile takeovers at deflated prices and, therefore, reliant on government intervention, which is problematic in its own way.[12]

Section II discusses the merits of the shareholder primacy and director primacy doctrines and argues for a balanced approach to regulating board passivity. Sections III and IV analyse the availability of the four most potent takeover defences (poison pills, equity restructuring, acquisitions and disposals, staggered boards) in Delaware and Germany. Section V, after concluding that these takeover defences are not available in New Zealand, discusses their availability but for New Zealand's strict board neutrality rule. Section VI compares the different jurisdictions and Section VII provides recommendations for law reform in New Zealand, drawing on the foregoing analysis of the regulation of takeover defences in Delaware and Germany.

II Shareholder primacy vs director primacy debate

This section reviews the theoretical and practical arguments which underpin the debate between the proponents of the shareholder primacy theory and those that support the director primacy theory.[13] The results of this review demonstrate that a balanced

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takeovers accounted for USD 575 billion worth of acquisition bids, or approximately 15 per cent of M&A volume; Richard Schoenberg and Daniel Thornton "The Impact of Bid Defences in Hostile Acquisitions" (2006) 24 European Management Journal 142 at 142; Greg Roumeliotis "Xerox abandons $35 billion hostile bid for HP" (1 April 2020) Reuters <www.reuters.com>.

[9] Rodolfo Araujo, Paul Massoud and Kosmas Papadopoulos "Blood in the Water: COVID-19 M&A Implications" (4 May 2020) Harvard Law School Forum on Corporate Governance <https://corpgov.law.harvard.edu/>.

[10] See section III(B)(1) for a description of a poison pill.

[11] Ofer Eldar and Michael D Wittry "The Return of Poison Pills: A First Look at 'Crisis Pills'" (2020) Duke Law School Public Law & Legal Theory Series 2020-18 at 1; and

[12] See Overseas Investment Act 2005; and Glenn Shewan, Andrew Petersen and Penny Pasley "COVID-19 Government passes urgent overseas investment legislation with key amendments" (28 May 2020) Bell Gully <www.bellgully.com>, but note that a discussion of the New Zealand overseas investment regime is beyond the scope of this paper.

[13] Note that the expression 'shareholder primacy theory' is used in this paper to describe the notion that "shareholders should have a significant say in how firms are run" and that the expression is not to be confused with the shareholder wealth maximization theory, which is perfectly compatible with the directory primacy theory: Maria Lucia Passador and Federico Riganti "Shareholders' Rights in Agency Conflicts: Selected Issues in the Transatlantic Debate" (2018) 42 Del J Corp L 569 at 574.

approach to the regulation of takeover defences is preferable, which supports the argument, made in section VII, for law reform in New Zealand.[14]

A Theoretical debate

The management of a corporation[15] commonly holds better information than the shareholders, which is often viewed as creating an incentive for a manager to engage in opportunistic behaviour for his or her own benefit, such as "skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal", and not to act for the welfare of the principal.[16] Hostile takeovers, which are usually effected via a tender offer against the will of the board,[17] have traditionally been seen as an important instrument to discipline the board (by creating the threat of removal if the directors "stray too far from the service of the shareholders") and, as a result, to mitigate the agency problems arising from the separation of ownership and control.[18]

The preponderance of academic opinion supports the shareholder primacy theory and, therefore, also the passivity thesis, whereby the board should be prohibited from interfering in any fashion in a hostile takeover via a tender offer.[19] In their seminal paper Easterbrook and Fischel advanced the passivity thesis for tender offers, arguing

[14] Note that New Zealand currently has a strict board neutrality rule in place: see section V(B)(2).

[15] Note that the term "management" here refers to both managers and the board, which are, however, different institutions with different roles in the corporation: see section II(A).

[16] Oliver E Williamson *The Economic Institutions of Capitalism* (The Free Press, New York, 1985) at 47–9; Kraakman and others, above n 1, at 29; Michael C Jensen and William H Meckling "Theory of the firm: Managerial behavior, agency costs and ownership structure" (1976) 3 Journal of Financial Economic 305 at 308; note that this agency problem is more prevalent in organisations with diffused ownership as opposed to organisations controlled by large blockholders (the intricacies of this distinction are, however, beyond the scope of this paper): Enriques and Volpin, above n 1, at 125.

[17] Bernard S Sharfman and Marc T Moore "Liberating the Market for Corporate Control" (20 July 2020) SSRN <https://ssrn.com/abstract=3656765> at 8.

[18] Burkart and Panunzi, above n 3, at 266; Frank H Easterbrook and Daniel R Fischel "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harv L Rev 1161 at 1169; David Kershaw *Company Law in Context: Text and Materials* (Oxford University Press, Oxford, 2009) at Web Chapter A page 7; and Henry G Manne "Mergers and the Market for Corporate Control" (1965) 73 Journal of Political Economy 110 at 112.

[19] Dale A Oesterle "Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis" (1985) 71 Cornell L Rev 53 at 53 and 54; and Burkart and Panunzi, above n 3, at 274.

that the board, when employing takeover defences, is rarely acting in the best interest of the shareholder:[20]

> The target's managers, however, have a substantial interest in preserving their corporation's independence and thus preserving their salaries and status; the less effective they have been as managers, the greater their interest in preventing a takeover.

In addition, Easterbrook and Fischel argued that "even resistance that ultimately elicits a higher bid is socially wasteful" because the higher bid translates into a loss borne by the bidder's shareholders and takeover battles consume "real resources".[21] Notably, the passivity thesis was not entirely accepted by the courts in Delaware and Germany,[22] and, although a limited form of the passivity thesis was accepted by the courts in England, Australia and New Zealand, this acceptance was primarily based on different theoretical foundations, namely that the issue of shares to prevent a hostile takeover amounts to an interference with the shareholders' constitutional voting and decision rights.[23]

In arguing for a private ordering solution (whereby it should ultimately be for shareholders, as owners of the shares, to decide whether the board can interfere in a tender offer), Peter Watts, Neil Campbell and Christopher Hare point out that law and economics arguments about the wealth creation and efficiency of active takeover markets are beside the point and should yield to the basic theory of freedom of contract, "namely the freedom of shareholders to allocate power through the constitution".[24] However, the authors themselves acknowledge that "Commonwealth case law so far provides little encouragement" for their argument.[25] In addition, the practical effects of a board neutrality rule should not be disregarded in favour of purist contract law theory, given that what matters to shareholders and other key players is not whether the board

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[20] Easterbrook and Fischel, above n 18, at 1175; see also Jaap Winter and others *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids* (European Commission, January 2002) at 21.

[21] Easterbrook and Fischel, above n 18, at 1175.

[22] *Unocal Corporation v Mesa Petroleum Co* 493 A 2d 946 (Del SC 1985) at 955; BGH (Federal Court of Justice) (13 March 1978) II ZR 142/76, (1978) NJW 1316 [*Kali and Salz*]; BGH (Federal Court of Justice) (6 October 1960) II ZR 150/58, (1961) NJW 26; and Albrecht Klein "Abwehrmöglichkeiten gegen feindliche Übernahmen in Deutschland" (1997) NJW 2085 at 2088.

[23] See, for the leading case: *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, [1974] 1 All ER 1126 (PC) at 837 and 838 per Lord Wilberforce.

[24] Peter Watts, Neil Campbell and Christopher Hare *Company Law in New Zealand (academic)* (2nd ed, Lexis Nexis, Wellington, 2016) at 564.

[25] See Watts, Campbell and Hare, above n 24, at 566, who also refer to some dictums in the case law that provide support for their argument after acknowledging the general lack of supporting case law.

neutrality rule complies with contract law theory, but what the economic implications are of a board condemned to complete passivity.

The private ordering solution (also called shareholder choice theory) also fails to recognise the character of a corporation, which is a fictional legal construct consisting of a nexus of contractual relationships.[26] Shareholders are merely one of the inputs in this fictional construct, meaning that ownership is not a meaningful concept in the corporate context.[27] The relationship between the board and shareholders is not "*legally* an agency-principal relationship because the principal (the shareholders) do not control the decisions of the agent (the directors)".[28] Instead, the rights of shareholders are determined by the contractual relationships, which are supplemented with regulation and case law.[29] As succinctly put by Stephen M Bainbridge, the "notion of shareholder ownership is thus irrelevant to the scope of the board's authority".[30]

The conflict of interest argument for a strict board neutrality rule (i.e. that accountability prevails over authority in a tender offer context) is also not all-encompassing. In this regard, Stephen M Bainbridge points out that a "key failing of the academic literature on takeovers is the almost universal conflation of the roles of corporate officers and directors … rarely recognizing any separate institutional role for the board".[31] In contrast, the Delaware courts have recognised the role of the board and especially the role of independent directors.[32] To take another example, in Germany the legislature has empowered the supervisory board, which has a comparable function to independent directors on an Anglo-Saxon board,[33] to approve the use of takeover defences by the

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[26] Stephen M Bainbridge "Unocal at 20: Director primacy in corporate takeovers" (2006) 31 Del J Corp L 769 at 813.

[27] At 813.

[28] Arthur R Pinto "Corporate Governance: Monitoring the Board of Directors in American Corporations" (1998) 46 Am J Comp L Supp 317 at 324 (emphasis added).

[29] At 325; and Bainbridge, above n 26, at 813.

[30] Stephen M Bainbridge "Were Easterbrook and Fischel right that target corporation boards should remain passive in the face of a hostile takeover bid? A comment on Sharfman and Moore. Part 2" (9 September 2020) ProfessorBainbridge.com <www.professorbainbridge.com>.

[31] Bainbridge, above n 26, at 818; but see Mark Gordon "Takeover Defenses Work. Is That Such a Bad Thing?" (2002) 55 Stan L Rev 819 at 831 for an example of academic recognition of the important role of independent directors in a tender offer, where the author suggests that "boards that are truly independent of senior management and other insiders ultimately 'do the right thing' and use the available takeover defenses to buy time and create leverage to find the best deal for stockholders".

[32] *Moran v Household International Inc* 500 A 2d 1346 (Del SC 1985) at 1356; *Unocal Corporation v Mesa Petroleum Co*, above n 22, at 955; *Aronson v Lewis* 473 A 2d 805 (Del SC 1984) at 815; and *Puma v Marriott* 283 A 2d 693 (Del Ch 1971) at 695.

[33] Victor Brudney "The Independent Director: Heavenly City or Potemkin Village?" (1982) 95 Harv L Rev 597 at 599, where the author notes that, in its narrowest terms, the institution of independent directors

management board during a tender offer.[34] While a tender offer to effect a hostile takeover may present to the managers of the target an inescapable conflict of interest, this is merely a potential problem for independent directors,[35] which is similar in kind to many other corporate transactions where the courts have encouraged independent directors to take an active role (for example, a management-sponsored leveraged buyout).[36]

However, even the fiercest proponents of the director primacy theory acknowledge that limits must be placed on the "large reservoir of authority" of the board due to accountability concerns in the context of a hostile takeover.[37] Therefore, the best solution to the conundrum is to strike a balance between shareholder primacy and director primacy so that the role of the board during a tender offer is restricted but not to the extent of complete passivity.

B Practical considerations

The empirical evidence is not conclusive as to whether a strict board neutrality rule should be preferred. While Sharfman and Moore, after thoroughly reviewing a large amount of empirical evidence, concluded that "hostile bids, in both the U.K. and U.S., have been financially beneficial to target shareholders and appear to be consistent with the efficiency/synergy theory of tender offers",[38] there is growing empirical literature documenting value-creating effects of antitakeover provisions (**ATPs**),[39] which highlights "the need for a more nuanced view of the ATP-value relation".[40] The

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derives from the need of overseeing the performance of management to safeguard the interests of shareholders.

[34] See section IV(A)(3).

[35] For example, the New Zealand Stock Exchange Listing Rules (a) define an independent director as "a Director who is not an Employee of the Issuer and who has no Disqualifying Relationship [which could reasonably be perceived to influence in any material way the Director's independence]" and (b) provide for at least two independent directors to sit on the board of a corporation to which the NZX Listing Rules apply: NZX Listing Rules 2020, r 2.1.1.

[36] Bainbridge, above n 26, at 820.

[37] At 821; and *Unocal Corporation v Mesa Petroleum Co*, above n 22, at 953.

[38] Sharfman and Moore, above n 17, at 55; for staggered boards in particular: Lucian Arye Bebchuk, John C Coates IV and Guhan Subramanian "The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants" (2002) 55 Stan L Rev 885 at 887, where the authors argue that 'effective' staggered boards reduce shareholder returns for targets.

[39] ATPs are takeover defences.

[40] W Drobetzb and Paul P Momtaza "Antitakeover Provisions and Firm Value: New Evidence from the M&A Market" (2020) 62 Journal of Corporate Finance 101594 at 4, 24 and 25, which focuses on the market for corporate control in Germany and concludes that, in light of the strong reliance on internal governance to discipline the management in Germany, the use of ATPs has long-run value-creating effects due to, for example, reducing short-termism; Thomas J Chemmanur, Imants Paeglis and Karen Simonyan "Management Quality and Antitakeover Provisions" (2011) 54 J Law Econ 651 at 684 and

empirical evidence in this growing literature finds a positive effect of ATPs on long-term value creation for various reasons, such as improved innovation, better long-term relationships and less short-termism.[41]

In Germany, the introduction of the Securities Acquisition and Takeover Act in 2002, which has afforded greater autonomy to the board in the context of a tender offer compared to the previous legislation and case law,[42] has not reduced takeover activity. Instead, tender offer activity has significantly increased since 2000 (the year of the Mannesmann/Vodafone takeover battle)[43] because of "the interest of private equity investors in the German market and the decrease of corporate shareholdings of banks".[44] Similarly, New Zealand, which implemented a strict board neutrality rule in 2000, has not seen a considerable change in takeover activity as a result, with takeover

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685, who find value-creating effects in the context of IPOs; William C Johnson, Jonathan M Karpoff and SanghoYi "The bonding hypothesis of takeover defenses: Evidence from IPO firms" (2015) 117 Journal of Financial Economics 307 at 329 and 330, also in the context of IPOs, but focusing on the positive effect of ATPs on the credibility of the commitments of firms to their business partners; Ling Cen, Sudipto Dasgupta and Rik Sen "Discipline or Disruption? Stakeholder Relationships and the Effect of Takeover Threat" (2016) 62 Management Science 2765, finding that ATPs have a strengthening effect on customer relationships because the threat of takeovers "can make it difficult to commit to long-term relationships"; Mark Humphery-Jenner "Takeover defenses, innovation, and value creation: Evidence from acquisition decisions" (2014) 35 Strategic Management Journal 668 at 687, finding a positive effect of ATPs on value creating innovation in the context of hard-to-value, high-tech and innovative firms; Miroslava Stráska and Gregory Waller "Do antitakeover provisions harm shareholders?" (2010) 16 Journal of Corporate Finance 487 at 497, finding value-creating effects in the context of firms with low bargaining power in the event of a tender offer; and Thomas J Chemmanur and Xuan Tian "Do Antitakeover Provisions Spur Corporate Innovation? A Regression Discontinuity Analysis" (2018) 53 Journal of Financial and Quantitative Analysis 1163 at 1191, who find a positive causal effect of antitakeover provisions on innovation, noting that the "positive effect of ATPs on innovation is more pronounced in firms that are subject to a larger degree of information asymmetry and operate in more competitive product markets".

[41] See footnote above.

[42] Carsten Gerner-Beuerle, David Kershaw and Matteo Solinas *Is the Board Neutrality Rule Trivial? Amnesia About Corporate Law In European Takeover Regulation* (London School of Economics and Political Science Law Department, LSE Working Papers 3/2011, March 2011) at 27.

[43] The hostile takeover of Mannesmann AG by Vodafone in 2000 was one of the largest merger and acquisition (M&A) deals in the world, worth more than USD 270 billion when adjusted for inflation: Martin Höpner and Gregory Jackson *An Emerging Market for Corporate Control? The Mannesmann Takeover and German Corporate Governance* (Max-Planck-Institut für Gesellschaftsforschung, Discussion Paper 01/4, September 2001) at 5; and Gautam Naik and Anita Raghavan "Vodafone, Mannesmann Set Takeover At $180.95 Billion After Long Struggle" (4 February 2000) The Wall Street Journal <www.wsj.com>. Note that the inflation adjustment is based on a cumulative rate of inflation of 49.7%.

[44] Joachim Rosengarten, Frank Burmeister and Martin Klein *Mergers and Acquisitions in Germany* (2nd ed, C H Beck, Munich, 2016) at 82.

activity being more dependent on cyclical patterns in the economy.[45] The takeover patterns in Germany and New Zealand are examples suggesting that the existence of a board neutrality rule is not determinative of takeover activity and that, therefore, its impact on the disciplining effect of the market for corporate control is often overstated.[46]

The effect of COVID-19 on the market for corporate control also suggests that takeover defences can have the valid purpose of protecting corporations against hostile takeovers at deflated prices and, thus, are desirable in circumstances where the share price of a corporation is depressed due to COVID-19 and not as a result of the "underlying firm fundamental or the true continuation value of the firm".[47] Eldar and Wittry found, in their recent article on the effects of COVID-19, that (a) the poison pill is making a comeback as a result of COVID-19,[48] (b) high-exposure firms experience a dramatic positive share price effect as a result of the adoption of the poison pill and (c) therefore, crisis pills that target stock acquisitions at deflated prices due to COVID-19 benefit shareholders, meaning that a strict board neutrality rule (invalidating poison pills) in crisis situations is unwarranted.[49]

Overall, the empirical evidence, especially the more recent papers, support the above expressed view that a balanced approach in allowing the use of takeover defences is preferable.

III Takeover defences in Delaware (United States)

A Background

The United States has been at the forefront of developing takeover defences because of the widely diffused ownership in corporations, high amounts of hostile takeover activity and the absence of a board neutrality rule.[50] For instance, during the wave of takeovers in the 1980s almost a quarter of large corporations in the United States received a tender

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[45] Bell Gully "Takeovers Market Practice Report" (June 2017) <www.bellgully.com> at 5.

[46] See Stephen M Bainbridge "Were Easterbrook and Fischel right that target corporation boards should remain passive in the face of a hostile takeover bid? A comment on Sharfman and Moore. Part 3" (9 September 2020) ProfessorBainbridge.com <www.professorbainbridge.com>, who makes a similar argument in regard to the United States; but see Sharfman and Moore, above n 17, at 2.

[47] Eldar and Wittry, above n 11, at 1.

[48] Between March and June 2020, at least 73 firms have announced the adoption of a poison pill: Eldar and Wittry, above n 11, at 1.

[49] At 24 and 31.

[50] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 6.

offer.[51] Therefore, the United States (specifically Delaware law) is a useful point of comparison to New Zealand, which has followed the opposite path by relying on a strict board neutrality rule. The following sections (sections III(B) – III(E)) outline the most effective and common takeover defences by reference to Delaware law because it is the home state of the majority of top United States companies (67.8 per cent of all Fortune 500 companies are incorporated in Delaware) and 80 per cent of all firms that go public.[52]

B The poison pill

1 Structure

The poison pill (also called shareholder rights plan) can be implemented in several different forms.[53] The most common forms are the "flip-in" rights plan and the "flip-over" rights plan, both of which are, in principle, available under Delaware law.[54] Under a "flip-in" rights plan, existing shareholders (excluding the bidder) can purchase shares in the target at a discount once the bidder has accumulated a specified percentage of the target's shares.[55] Due to its potency, this form has become the most common poison pill adopted by United States companies.[56] The "flip-over" rights plan operates similarly to the "flip-in" form, but the target's shareholders are able to purchase shares in the bidder at a discount, as opposed to the target, in the event of a successful merger.[57]

The effect of a triggered poison pill is to significantly dilute the value of the bidder's already purchased shares in the target. The poison pill is considered to be a board

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[51] Mark L Mitchell and J Harold Mulherin "The impact of industry shocks on takeover and restructuring activity" (1996) 41 Journal of Financial Economics 193 at 199; and Burkart and Panunzi, above n 3, at 266.

[52] Delaware Division of Corporations "2019 Annual Report Statistics" (State of Delaware, 2019).

[53] See John P Lowry "Poison pills in U.S. corporations - a re-examination" (1992) JBL 337 for an explanation of the principal forms of the poison pill.

[54] *Moran v Household International Inc*, above n 32, at 1355; *Stahl v Apple Bancorp* 59 USLW 2150 (Del Ch 1990) at 1586; and Lowry, above n 53, at 337.

[55] At 340; *Stahl v Apple Bancorp*, above n 54, at 1586, where the court refused to find in an application for summary judgment that the "flip-in" rights plan of the defendant corporation was "beyond the Board's power to adopt"; *Yucaipa American Alliance Fund II LP v Riggio* 1 A 3d 310 (Del Ch 2010) at 335, 353 and 360, where the court found after analysing *Moran* and *Stahl* that the board had not breached its fiduciary duties by implementing a "flip-in" rights plan; aff'd *Yucaipa American Alliance Fund II LP v Riggio* 15 A 3d 218 (Del SC 2011); *Stroud v Grace* 606 A 2d 75 (Del SC 1992) at 91 and 92, where the court cited *Stahl v Apple Bancorp* with approval; and Marcel Kahan and Edward Rock "Anti-Activist Poison Pills" (2019) 99 B U L Rev 915 at 921.

[56] Lowry, above n 53, at 340.

[57] David Kershaw "The Illusion of Importance: Reconsidering the UK's Takeover Defence Prohibition" (2007) 56 ICLQ 269 at 272 and 273.

controlled takeover defence because it can be implemented by the issuance of warrants[58] as an interim dividend, which does not require shareholder approval.[59] While the warrants are of no economic value upon distribution, once a trigger event occurs, the terms of the warrants change significantly to enable eligible (not the bidder) option holders to purchase newly issued shares of the target or bidder at a sizeable discount (usually 50 per cent of the shares' current price), unless the board redeems the warrants.[60]

2 Proxy contests

A bidder may seek to elect new board members to redeem the warrants before the bidder triggers the threshold, but the success and duration of such a strategy depends partly on whether the corporation's board is staggered[61] and whether there is a prohibition on removing directors without cause.[62] However, while the poison pill is one of the most potent takeover defences, it would not automatically stop a tender offer in its tracks. In practice, poison pills are rarely triggered by bidders.[63] A bidder with a stake in the target that is well below the pill's trigger threshold has (despite the low stake) an incentive, namely the profits from acquiring the target, and, thus, the required credibility to conduct a proxy contest, redeem the warrants and facilitate the takeover.[64]

3 Fiduciary duties of loyalty and due care

The courts have devised mechanisms to limit the use of poison pills and other takeover defences. Under the common law of Delaware, similarly to many other common law jurisdictions, there is a fiduciary relationship of loyalty and care between the directors, the corporation and its shareholders.[65] The fiduciary duty of loyalty, owed by directors

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[58] Warrants are rights or options to acquire from the corporation shares of its capital stock.

[59] Kershaw, above n 57, at 273; and Delaware General Corporation Law 8 Del C 1953 § 157.

[60] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 7.

[61] The staggered board defence is discussed in section III (E).

[62] Brett H McDonnell "Shareholder Bylaws, Shareholder Nominations, and Poison Pills" (2005) 3 BBLJ 205 at 209.

[63] Jordan M Barry "Takeover defenses: the lay of the land and disputed sign posts" in Claire A Hill and Steven Davidoff Solomon (eds) *Research Handbook on Mergers and Acquisitions* (Edward Elgar Publishing, Cheltenham, 2016) 181 at 182.

[64] Kahan and Rock, above n 55, at 923.

[65] *Guth v Loft Inc* 5 A 2d 503 (Del SC 1939) at 510; note that directors in limited partnerships and limited liability companies are able to modify or eliminate their fiduciary duties in the partnership agreement or the limited liability corporation agreement: Brent J Horton "Modifying Fiduciary Duties in Delaware: Observing Ten Years of Decisional Law" (2016) 40 Del J Corp L 921 at 923; while "there are now more than twice as many entities formed in Delaware as LLCs and other alternative entities as are formed as corporations", this paper focuses solely on corporations, where the fiduciary duties of loyalty and due care cannot be modified or eliminated by agreement: Gail Weinstein and others "Fried Frank Discusses the Obligations of LLC Directors and Managers" (20 June 2018) Columbia Law School's Blog on Corporations and the Capital Markets <https://clsbluesky.law.columbia.edu/>.

to the corporation and its shareholders, prevents directors from exploiting their position for self-interest, prohibiting, among other things, the misappropriation of assets, the usurping of business opportunities, self-dealing and competing.[66]

The fiduciary duty of care, which requires directors to exercise care in their decision-making, is subject to the business judgment rule, which has been described as the "cornerstone of the jurisprudence of the duty of care in the corporate context".[67] The business judgment rule creates a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company".[68] Therefore, in effect, the concept of gross negligence is the appropriate standard upon which director liability is predicated.[69]

Under the Delaware General Corporation Law, corporations are able to include a section 102(b)(7) provision in their certificates of incorporation, which will "exculpate director defendants from paying monetary damages that are exclusively attributable to a violation of the duty of care".[70] While this exculpatory provision, which came into effect in 1986 in response to an increased scarcity of qualified, disinterested directors, has been adopted by the shareholders of many Delaware corporations,[71] the effectiveness of such exculpatory provisions has been doubted because the duties of care and loyalty are so malleable that, in many cases, directors can be held liable under both duties and a section 102(b)(7) provision does not exculpate directors regarding

[66] *Auriga Capital Corp v Gatz Properties* 40 A 3d 839 (Del Ch 2012) at 844; and Horton, above n 65, at 934.

[67] Horton, above n 65, at 936; and Elizabeth S Miller and Thomas E Rutledge "The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?" (2005) 30 Del J Corp L 343 at 343.

[68] *Aronson v Lewis*, above n 32, at 812, where it was acknowledged that the business judgment rule derives from the managerial prerogatives of Delaware directors under section 141(a) of the Delaware General Corporation Law (8 Del C 1953); the case was overruled in *Brehm v Eisner* 746 A 2d 244 (Del SC 2000) at 253, however, only on a procedural point of law that is not relevant for this paper.

[69] *Smith v Van Gorkom* 488 A 2d 858 (Del SC 1985) at 873; and *Aronson v Lewis*, above n 32, at 812.

[70] Delaware General Corporation Law 8 Del C § 102; and *Emerald Partners v Berlin* 787 A 2d 85 (Del SC 2001) at 92.

[71] *Emerald Partners v Berlin*, above n 70, at 90.

their duty of loyalty.[72] A section 102(b)(7) provision also does not protect directors where the plaintiffs have asserted a claim for injunctive relief.[73]

4 The enhanced scrutiny standard developed in Unocal

In the context of tender offers, the courts have developed a higher standard of scrutiny into the review of the board's business judgment.[74] In *Unocal Corporation v Mesa Petroleum Co* (*Unocal*), the Delaware Supreme Court developed a standard of review to assess whether a poison pill was being exercised consistently with the director's fiduciary duty of loyalty "to act in the best interests of the corporation's stockholders" (the *Unocal* standard).[75]

As a starting point, the Delaware Supreme Court recognised that "in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality".[76] This is because the board's powers derive from its fundamental duty to protect the corporate enterprise, which includes shareholders, from "harm reasonably perceived, irrespective of its source".[77] The court approved its previous decision in *Pogostin v Rice*, where it held that the business judgment rule is applicable in the context of tender offers.[78]

However, the court laid down a two-step test that must be satisfied before a defensive measure will be protected by the business judgment rule.[79] The imposition of these additional requirements recognises the entrenchment effect of the pill and takeover defences generally.[80] First, the board that adopted the measure in question must have

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[72] Jonathan W Groessl "Delaware's New Section 102(b)(7): Boon or Bane for Corporate Directors?" (1988) 37 DePaul L Rev 411 at 441; but see *In re Cornerstone Therapeutics Inc, Stockholder Litigation* 115 A 3d 1173 (Del SC 2015) at 1186 and 1187, where the court held that when the plaintiffs have pled no facts to support an inference that "seemingly independent directors approved a conflicted transaction for improper reasons, and thus, those directors may have breached their duty of loyalty", a section 102(b)(7) exculpatory provision requires dismissal of the complaint.

[73] Delaware General Corporation Law 8 Del C § 102; Greg Beaman "Delaware Supreme Court Clarifies That Section 102(b)(7) Charter Provisions May Be Basis For Dismissal At The Pleading Stage In Controlling Stockholder Transactions" (20 May 2015) Orrick Herrington & Sutcliffe LLP <www.orrick.com>.

[74] *Stahl v Apple Bancorp*, above n 54, at 1124.

[75] *Unocal Corporation v Mesa Petroleum Co*, above n 22, at 955.

[76] At 954.

[77] At 954.

[78] *Pogostin v Rice* 480 A 2d 619 (Del SC 1984) at 627; and *Unocal Corporation v Mesa Petroleum Co*, above n 22, at 954.

[79] See *Yucaipa American Alliance Fund II LP v Riggio* (Ch), above n 55, at 336 for a succinct summary of the *Unocal* standard.

[80] Kahan and Rock, above n 55, at 926.

had “reasonable grounds for believing that a danger to corporate policy and effectiveness existed”.[81] Secondly, the defensive response must have been reasonable in relation to the threat posed.[82] In practice, the principal threat advanced to justify the use of takeover defences is that the bid price is insufficient (i.e. that the shareholders are under a mistaken belief that the offer is adequate) and the courts have shown substantial deference to a board’s assessment of the adequacy of the bidder’s offer.[83]

In addition, the Delaware Supreme Court later widened the scope of reasonableness, which is assessed in the second step of the *Unocal* test, by noting that the *Unocal* proportionality test requires the focus of enhanced judicial scrutiny to shift to ‘the range of reasonableness’” and the ”need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders”.[84]

The outcome of the line of cases following the *Unocal* standard is that, while the board has wide discretionary powers under the business judgment rule, these powers are restricted to a limited extent during a tender offer.[85] Since *Unocal* established the enhanced scrutiny standard with a view to protect shareholders against the potential conflicts that directors face when using takeover defences,[86] the relevant fiduciary duty analysis should be that of loyalty and, thus, a section 102(b)(7) provision would not preclude an action for damages under *Unocal*, where there is a claim that the board has implemented a takeover defence for an improper purpose.

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[81] *Unocal Corporation v Mesa Petroleum Co*, above n 22, at 955.

[82] At 955.

[83] Kahan and Rock, above n 55, at 922; see, for example: *Stahl v Apple Bancorp*, above n 54, at 1119 and 1124; and *Paramount Communications Inc v Time Inc* 571 A 2d 1140 (Del SC 1990) at 1153, where the court held that the inadequate value was one of several threats that ultimately rendered the board’s defensive actions reasonable.

[84] *Unitrin Inc v American General Corp* 651 A 2d 1361 at 1388 (Del SC 1995); Iman Anabtawi “The Twilight of Enhanced Scrutiny in Delaware M&A Jurisprudence” (2019) 43 Del J Corp L 161 at 172 and 173, noting that *Unocal* may no longer provides the same level of enhanced review that it once promised.

[85] But see *Corwin v KKR Financial Holdings LLC* 125 A 3d 304 (Del SC 2015) at 312, where the Delaware Supreme Court held that “*Unocal* and *Revlon* are primarily designed to give stockholders and the Court of Chancery the tool of injunctive relief to address important M&A decisions in real time, before closing” (however, it should be noted that the court here appears to misunderstand the rationale for the enhanced *Unocal* standard and that the enhanced standard derives from the board’s fiduciary duty of loyalty as opposed to its fiduciary duty of due care; see also Katie Clemmons “Dissecting Revlon: Severing the Standard of Conduct from the Standard of Review in Post-Closing Litigation” (2020) 73 Vand L Rev 267 at 285.

[86] *Unocal Corporation v Mesa Petroleum Co*, above n 22, at 955.

C Equity restructuring defence

1 Structure

The equity restructuring defence, which involves the issue of a significant number of new shares to a friendly third party is another effective takeover defence.[87] It operates as a post-bid defence, as opposed to the poison pill, which is usually implemented before the corporation receives a bid in order to reduce the corporation's attractiveness to potential bidders.[88] This measure is particularly effective in corporations with diffused ownership because it creates a major blockholder, which complicates the acquisition of sufficient shares to control the corporation.[89] In addition, the issuance of new shares to a friendly third party has the effect of diluting the existing shareholding of the bidder.[90] A corporation may also buy-back its own shares, which would allow it to buy-back the shares of a hostile bidder at a premium (the greenmail defence) or change the proportionate stake (i.e. voting power) of the bidder, a friendly shareholder or insider.[91]

2 Legal availability

The legal availability of this defence depends on whether the board can issue shares non-pre-emptively (i.e. without having to first offer the shares to the existing shareholders) without shareholder approval.[92] Under Delaware's General Corporation Law, the directors of a corporation have the power to issue shares, if the authorised share capital of the corporation is not depleted, up to the amount authorised in the corporation's constitution.[93] If there is insufficient authorised share capital, the board would require shareholder approval to raise the authorised share capital.[94] However, most Delaware companies have enough authorised share capital to enable the directors to issues a significant amount of shares to avoid the success of a tender offer without

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[87] Rodd Levy *Takeovers: Law & Strategy* (5th ed, Thomson Reuters, Sydney, 2017) at 305; and Schoenberg and Thornton, above n 8.

[88] Schoenberg and Thornton, above n 8, at 142.

[89] Levy, above n 87, at 305.

[90] Levy, above n 87, at 305.

[91] Delaware General Corporation Law 8 Del C § 160; and Gerner-Beuerle, Kershaw and Solinas, above n 42, at 9.

[92] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 8.

[93] Delaware General Corporation Law 8 Del C § 161.

[94] Delaware General Corporation Law 8 Del C § 242, which specifies that an increase or decrease of the authorised capital stock and other amendments of the certificate of incorporation after receipt of payment for stock requires a special meeting of the stockholders or an annual meeting of the stockholders to be effected.

shareholder approval.[95] In addition, the board in a Delaware corporation is able to buy-back its own shares.[96]

If a corporation is listed on the New York Stock Exchange, it is required to receive shareholder approval before issuing, in a private placement at a discounted price, common stock (or convertible securities) constituting "20% or more of the company's pre-transaction outstanding common stock or voting power".[97]

3 The enhanced Revlon standard in sale transactions

An important and complex line of cases has considered the role of directors in situations where the target is up for sale in the sense that it has become "apparent to all that the break-up of the corporation was inevitable".[98] These cases may, for example, apply in situations where the board looks for a white knight to take control over the target instead of the hostile bidder.

In *Revlon*, the Delaware Supreme Court granted an injunction that barred a lock-up option[99], a no-shop agreement (promise not to look for other buyers) and a cancellation fee (to be payable if the transaction was aborted) that were part of a deal for a leveraged buyout of the target by a white knight.[100] The court held that once the break-up of the corporation had become a reality, the board's role changed "from defenders of the corporate bastion to auctioneers charged with getting the best price for stockholders at the sale of the corporation" and that, therefore, the board ought to obtain the best offer reasonably available for shareholders.[101]

While the court's thorough investigation of the board's decision making process indicated that the courts would engage in a substantive review of the sale process as administered by the target's board, the *Revlon* review has recently been integrated into

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[95] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 8.

[96] Delaware General Corporation Law 8 Del C § 160.

[97] New York Stock Exchange *Listed Company Manual* at 312.03; and Joshua N Korff, Ross M Leff and Robert M Hayward "NYSE Improves 20% Rule Requiring Shareholder Approval of Certain Private Placements" (28 March 2019) Kirkland & Ellis <www.kirkland.com>.

[98] *Revlon Inc v MacAndrews & Forbes Holdings Inc* 506 A 2d 173 (Del SC 1986) at 182.

[99] Black's Law Dictionary 2nd ed "Lock-up option" <https://thelawdictionary.org/lock-up-option/>: "When a company allows a white knight to purchase its most valuable assets to prevent a hostile takeover".

[100] *Revlon Inc v MacAndrews & Forbes Holdings Inc*, above n 98, at 175; and Clemmons, above n 85, at 278.

[101] *Revlon Inc v MacAndrews & Forbes Holdings Inc*, above n 98, at 182; and Clemmons, above n 85, at 279.

the traditional fiduciary duties of the board.[102] The *Revlon* review has also been restricted to cases where the control transaction was not ratified through "a fully informed, uncoerced" cleansing vote of the disinterested shareholders.[103]

There is also uncertainty as to whether the *Revlon* duties are barred in respect of a post-closing claim for monetary damages by a section 102(b)(7) exculpatory provision. The recent decision of the Delaware Supreme Court in *Kahn v Stern* leaves open the possibility for a monetary damages claim where a breach of *Revlon* duties by directors is pleaded post-closing.[104] A section 102(b)(7) exculpatory provision, therefore, appears not to provide a blanket exception from the *Revlon* duties, which is conceptually coherent with *Revlon* when analysed as a duty of loyalty case or as a case of independent judicial determination.[105]

D Acquisition and disposal defence

During a tender offer, a board may also dispose of an asset that the bidder is interested in or, in the alternative, acquire an asset that will obstruct the takeover, such as an asset that will create antitrust (i.e. competition) or other regulatory issues.[106] The disposal of a key asset (i.e. crown jewel) may be absolute or be implemented through a conditional arrangement, which, in the event of a tender offer, results in the asset being sold.[107]

A change-of-control clause regarding a key asset of the target, which gives to a third party additional rights in the asset in the event of a takeover of the target, would be a potential mode of implementing this takeover defence.[108] Practical difficulties associated with this defence include the difficulty of separating out key assets of the corporation and finding a third party willing to enter into an arrangement for the sale of the target's key asset(s).[109] Selling assets to an insider will likely be in breach of the rules against self-dealing.

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[102] Anabtawi, above n 84, at 172; and *In re Cornerstone Therapeutics Inc, Stockholder Litigation*, above n 72, at 1175 and 1177.

[103] *Corwin v KKR Financial Holdings LLC*, above n 85, at 308 and 309, which is sound in principle because a cleansing vote amounts to ex-post shareholder approval; the cleansing vote ratification doctrine is beyond the scope of this paper, but see Clemmons, above n 85, for a detailed review of *Revlon* and subsequent cases.

[104] *Kahn v Stern* 183 A 3d 715, 2018 WL 1341719 (Del SC 2018) at 1.

[105] Clemmons, above n 85, at 288; and Groessl, above n 72, at 439 and 440.

[106] Richard S Ruback "An Overview of Takeover Defenses" in Alan J Auerbach (ed) *Mergers and Acquisitions* (University of Chicago Press, Chicago, 1987) 49 at 64.

[107] Levy, above n 87, at 317.

[108] At 317.

[109] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 8.

Under the Delaware General Corporation Law, the board has the power to sell assets of the target, unless the sale involves all or substantially all of the target's asset, in which case shareholder approval is required.[110]

E Staggered board

A staggered board is considered to be one of the most potent takeover defences because it presents a significant hurdle to acquirers seeking to obtain a majority position on the board to disarm other takeover defences, such as the aforementioned poison pill.[111] A staggered board is a corporate board with directors who are elected to serve for terms that are different in length.[112]

Under section 141(d) of the Delaware General Corporation Law, a corporation may elect to divide its directors into one, two or three classes.[113] Typically, a staggered board is split up into three classes, with only one class up for election each year.[114] If this typical three class structure is implemented, it will take a potential acquirer two successful annual election contests, which may be spread out over a 13-month period, to obtain a majority position on the target's board.[115] A staggered board structure, coupled with a poison pill can, therefore, enable the board to "just say no" to a hostile takeover attempt.[116]

The implementation of a staggered board provides the board with a further opportunity to protect itself. Under section 141(k)(1) of the Delaware General Corporation Law, any director may be removed with or without cause by the holders of a majority of the shares at an election of directors, except where the board of a corporation is staggered,

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[110] Delaware General Corporation Law 8 Del C § 271.

[111] Robert S Reder and Lauren Messonnier Meyers "Delaware Corporate Law Bulletin: Delaware Court Invalidates Commonly-Used Corporate Classified Board Provision as Contrary to Delaware Law" (2016) 69 Vand L Rev 177 at 178.

[112] David L Scott *Wall Street Words* (3rd ed, Houghton Mifflin, New York, 2003); note that the terms "classified" and "staggered" board are often used interchangeably, but while classified boards are always staggered boards, staggered boards are not always classified boards. With this minor distinction in mind, this paper will use the term "staggered board" from this point to refer to both "staggered" and "classified" boards.

[113] Delaware General Corporation Law 8 Del C § 141(d).

[114] Reder and Meyers, above n 111, at 178.

[115] Delaware General Corporation Law 8 Del C § 211(c).

[116] See *Airgas Inc v Air Products and Chemicals Inc* 8 A 3d 1182 (Del SC 2010) [*Airgas*]; and D Keith Clouser "Staggered Boards And Annual Meetings: Closing A Loophole In The Staggered Board Defense" (2012) 14 U Pa J Bus L 559 at 582, where the author argues that the effect of *Airgas* is "to put out of reach a change in the date of the annual meeting for corporations employing staggered boards", and that this "result impinges on the shareholder franchise".

in which case the shareholders may effect a removal of a director only for cause.[117] This protection does not extend to a board that has been previously staggered but, owing to pressure from institutional investors or other reasons, has been de-staggered.[118]

From a practical perspective, the number of corporations with a staggered board has fallen dramatically since 2000, when 300 companies in the S&P 500 had staggered boards, due to shareholder activism.[119] As of January 2017, less than 50 corporations in the S&P 500 had staggered boards.[120] This trend, which can also be observed in regard to the poison pill, demonstrates a reallocation of regulatory power from courts to equity markets driven by the shift from retail to institutional ownership.[121]

IV Takeover defences in Germany

A Background

Historically, the shareholder environment in Germany was dominated by banks, large blockholders and cross-ownership and, thus, Germany has traditionally been considered an insider market.[122] However, Germany's equity markets have experienced a significant shift over the past 20 years.[123] The ownership of German companies has opened up and there is a continuous increase of shares in German companies held by institutional investors.[124]

In terms of the legislative landscape in Germany, the Securities Acquisition and Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz*) (the **WpÜG**) prohibits, after a bidder has published a tender offer, any action by the board of the target that could frustrate the success of the offer.[125] However, it has been argued that the exceptions to the board neutrality rule in WpÜG § 33(1) effectively nullify its

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[117] Delaware General Corporation Law 8 Del C § 141(k)(1).

[118] *In re Vaalco Energy Inc Consol Stockholder Litigation* CA No 11775-VCL (Del Ch 2015).

[119] Zohar Goshen and Sharon Hannes "The Death of Corporate Law" (2019) 94 NYU L Rev 263 at 278 and 279.

[120] At 278 and 279.

[121] At 279, 314 and 315.

[122] Jeremy Edwards and Marcus Nibler *Corporate Governance in Germany: The Influence of Banks and Large Equity-Holders* (ifo Institute for Economic Research, Working Paper, 1999) at 1; and Julian Franks and Colin Mayer "Ownership and Control of German Corporations" (2001) 14 The Review of Financial Studies 943 at 944.

[123] Wolf-Georg Ringe *Stewardship and Shareholder Engagement in Germany* (European Corporate Governance Institute, Law Working Paper N 501/2020, March 2020) at 12.

[124] At 12.

[125] WpÜG § 33(1).

effectiveness.[126] While this argument is overly critical,[127] it is nevertheless appropriate to classify the board neutrality rule in the WpÜG as nuanced in the sense that it provides the management and supervisory board with some flexibility during a tender offer. Given that this paper argues for a balanced regulatory approach to allowing the use of takeover defences in New Zealand, Germany provides an instructive point of comparison and source of legislation and case law that may be suitable for transplantation into New Zealand law.

To understand the most important exception to the board neutrality rule in the WpÜG (i.e. supervisory board approval), the governance structure of the German stock corporation (*Aktiengesellschaft*) (the **AG**), which is largely regulated by the Stock Corporation Act (*Aktiengesetz*) (the **AktG**), will be outlined below.

1 The management board and supervisory board

From 1870, due to the declining role of the Government in the supervision of the incorporation and conduct of AGs, an AG was required to have, additionally to the management board (*Vorstand*), a supervisory board (*Aufsichtsrat*), which was tasked with the supervision of the management board.[128] The management board, which is in essence the equivalent of the single board in Anglo-Saxon companies, is tasked with the management of the AG, whereas the supervisory board is not competent to instruct the management board on management matters.[129]

The introduction of the WpÜG ended a longstanding debate in the literature about the existence and scope of a general duty of neutrality owed by the management board

[126] WpÜG § 33; Gerner-Beuerle, Kershaw and Solinas, above n 42, at 27; and see section IV(A)(3).

[127] WpÜG § 33(1) does not provide the management board of an AG with the same latitude than a Delaware board, which is protected by the business judgment rule (subject to *Unocal*) during a tender offer: Michael Schlitt "WpÜG §§ 32–39" in Wulf Goette and Mathias Habersack (ed) *Münchener Kommentar zum Aktiengesetz* (4th ed, C H Beck, Munich, 2017) vol 6 WpÜG at § 33 [53]; compare to discussion of Delaware law in section III.

[128] Klaus J Hopt "Der Aufsichtsrat – Bedeutungswandel, Konvergenz, unternehmerische Mitverantwortung, Pflichten- und Haftungszuwachs (The Supervisory Board – Its Growing Importance and the Move toward Convergence, Entrepreneurial Co-Responsibility, Broader Legal Duties and Stricter Liability)" (2019) 48 ZGR 507 at 510 and 511.

[129] AktG §76(1) and §111(4); Jens Koch *Hüffer / Koch Aktiengesetz: AktG* (14th ed, C H Beck, Munich, 2020) at § 76 [5]; BGH (Federal Court of Justice) (5 May 2008) II ZR 108/07, (2008) ZIP 1230 at [13]; however, the prima facie clear distinction between the functions of the management and supervisory board blurs to some extent on closer inspection because the supervisory board, through its (also anticipatory) supervisory role, becomes increasingly involved in the management of the AG: Koch, above n 129, at § 76 [2].

under the AktG during a tender offer.[130] It is now widely accepted that a general duty of neutrality under the AktG (if it exists) cannot be stricter than the board neutrality rule contained in the WpÜG, for that, any contrary interpretation would create the anomalous result that the management board is subject to a stricter neutrality duty outside of a tender offer scenario than during a tender offer.[131]

2 The general meeting

The general meeting is not able to give instructions to the management board, unless the management board expressly requests the general meeting to decide on management issues.[132] Instead, the general meeting decides on a limited number of matters listed in AktG § 119, which includes the election of members of the supervisory board.[133] However, in its seminal *Holzmüller* decision, the Federal Court of Justice (*Bundesgerichtshof*) (the **BGH**) modified the statutory allocation of competences by holding that there is a shift in competences in certain circumstances from the management board to the general meeting (*Holzmüller* doctrine).[134]

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[130] Joachim Freiherr v Falkenhausen and Henning v Klitzing "Wandelanleihen als poison pill" (2006) ZIP 1513 at 1516.

[131] Falkenhausen and Klitzing, above n 130; Hans Christoph Grigoleit "§§ 76–85" in Hans Christoph Grigoleit (ed) *Aktiengesetz: AktG* (2nd ed, C H Beck, Munich, 2020) at §76 [42]; Koch, above n 129, at § 76 [40], arguing that a general duty of neutrality under the AktG does not exist; and Gerald Spindler "Vor § 76, §§ 76–94" in Georg Annuß, Mathias Habersack and Gerald Spindler (eds) *Münchener Kommentar zum Aktiengesetz* (5th ed, C H Beck, Munich, 2019) vol 2 AktG §§ 76–117 at § 76 [40], arguing that the duty of neutrality under the AktG was defined in WpÜG § 33 but not extinguished so that the duty of neutrality under the AktG applies to pre-bid defences as well (however, provided that most pre-bid defences discussed here require ex-ante shareholder approval, the argument of whether a duty of neutrality under the AktG exists and whether it extends to pre-bid defences is of little practical relevance).

[132] Rosengarten, Burmeister and Klein, above n 44, at 10; Koch, above n 129, at § 76 [5]; and BGH (Federal Court of Justice) (26 April 2004) II ZR 155/02, NJW 2004 1860 [*Gelatine I*] at 1864, where the court explained that this rule exists because, considering its inhomogeneous and arbitrary composition and its disconnection from the day-to-day management of the AG, the whole structure of the general meeting is not suited for participating in the AG's management.

[133] AktG §119(1).

[134] BGH (Federal Court of Justice) (25 February 1982) II ZR 174/80, (1982) ZIP 568 [*Holzmüller*] at 571, where the court argued that the ability of the management board to request the general meeting to decide on management issues under AktG §119(2) changes into a duty to consult the general meeting if the board's actions have the consequences of interfering "so substantially with the rights of the members and their financial interests that the board cannot reasonably assume that it may take a decision in its own right and without participation of the general meeting"; see Gerner-Beuerle, Kershaw and Solinas, above n 42, at 42; however, the BGH later clarified that the shift in competences does not arise under AktG §119(2) or as an analogy to the matters expressly listed in AktG §119(1) but that, instead, the shift is a result of overt judicial development of AktG §119 with the effect that a vote of a three-quarter majority in value of the shareholders is required to approve the board's actions and that the legal consequences of the shift of competences does not extend to any third parties: *Gelatine I*, above n 132, at 1863; Jochen

The boundaries of this doctrine were clarified in two later decisions of the BGH.[135] In the *Gelantine* decisions, the BGH restricted the application of the *Holzmüller* doctrine to situations where the management decision at issue is of a nature akin to one that would require an alteration of the constitution of the AG.[136] What is thus required for the competences to shift to the general meeting is a decision over assets of a similar scale to *Holzmüller*, where the management board sought to divest the most valuable part of the AG, which represented approximately 80 percent of its total assets, to a subsidiary.[137]

In *Holzmüller,* the BGH found that a shift in competences had occurred because, although the wealth of the shareholders was not impaired, the divesture had an intermediating effect that deprived the shareholders of their rights under AktG §119, including the ability to vote on changes to the constitution and increases or decreases in capital, and that, therefore, the shareholders are able to claim against the corporation directly, as opposed to claiming against the directors in the form of derivative action for damages, for a violation of their membership rights, which allows for the remedy of rescission or, if not possible, a declaration that the board's actions are null and void.[138]

The intermediating effect that occurred as a result of the divesture in *Holzmüller* is, however, not the only situation that warrants a shift in competences. Unfortunately, the

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Hoffmann "AktG §§ 118–120a" in Martin Henssler (ed) *Beck OGK* (online ed, C H Beck, Munich, 1 July 2020) at §119 [30]; Koch, above n 129, at § 119 [18]; and Clemens Just "Ungeschriebene Mitwirkungsbefugnisse der AG-Hauptversammlung im Sinne der Holzmüller-Rechtsprechung bei annähernd Satzungsänderungen erfordernden Geschäftsführungsmaßnahmen („Gelatine I")" (2004) EWiR 573 at 574.

[135] *Gelatine I*, above n 132; and BGH (Federal Court of Justice) (26 April 2004) II ZR 154/02, (2004) ZIP 1001 [*Gelatine II*].

[136] *Gelatine I*, above n 132, at 1864; Hoffmann, above n 134, at §119 [31]; and Just, above n 134, at 574.

[137] OLG Hamburg (Higher Regional Court) (5 September 1980) 11 U 1/80, (1980) ZIP 1000 at 1005; rev'd *Gelatine I*, above n 132; and Koch, above n 129, at § 119 [16]; note, however, that a divesture of 70 per cent of total assets may be sufficiently close to the *Holzmüller* threshold to warrant a shift in competences to the general meeting: Hoffmann, above n 134, at §119 [31]; importantly, there is no rigid percentage threshold that determines when the competences shift, instead any percentage will only be a factor, albeit presumably an important one, in assessing on a case by case basis whether holistically the actions are of sufficient economic magnitude to necessitate a shift in the competences to the general meeting: *Gelatine I*, above n 132, at 1860; OLG Stuttgart (Higher Regional Court) (13 July 2005) 20 U 1/05, (2005) AG 693 at [15]; Mathias Habersack *Emmerich / Habersack Aktien- und GmbH-Konzernrecht* (9th ed, C H Beck, Munich, 2019) at 47; Holger Fleischer "Ungeschriebene Hauptversammlungszuständigkeiten im Aktienrecht: Von ‚Holzmülle' zu ‚Gelatine'" (2004) NJW 2335 at 2339; and Hoffmann, above n 134, at §119 [51].

[138] *Holzmüller*, above n 134, at 572; and Gerner-Beuerle, Kershaw and Solinas, above n 42, at 42.

Gelantine decisions of the BGH did not provide guidance in this regard.[139] It has been argued in the literature that the *Holzmüller* doctrine also applies in the following scenarios:

(a) significant acquisitions of shares or assets that lead to a fundamental change in the structure of the AG;[140]
(b) the disposal of a significant number of shares or significant assets that lead to a fundamental change in the structure of the AG.[141]

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[139] Jochen Hoffmann "AktG §§ 118–120a" in Martin Henssler (ed) *Beck OGK* (online ed, C H Beck, Munich, 1 July 2020) at §119 [33].

[140] Hoffmann, above n 134, at §119 [35]–[41], where the author points to the acquisition of Dresdner Bank AG by Commerzbank AG for EUR 9.8 billion in 2009, which contributed substantially to the need of Commerzbank AG to be recapitalised by the German government during the global financial crisis, and the acquisition of Monsanto AG by Bayer AG, which in the author's view may satisfy the *Holzmüller* threshold, although the author was careful not to express a final opinion on this matter; LG Frankfurt am Main (Regional Court) (15 December 2009) 3-5 O 208/09, (2010) ZIP 429 at 432, where the court held that the acquisition of shares can fall within the *Holzmüller* doctrine, if there is a fundamental change in the structure of the AG due to a significant increase in debt, which in turn materially increases the likelihood of insolvency; rev'd OLG Frankfurt am Main (Higher Regional Court) (7 December 2010) 5 U 29/10, (2011) NZG 62 at 64, where the OLG, which focussed on a clause in the constitution that permitted the acquisition of shares, held that the view of the LG that, holistically, the change of the capital structure of Commerzbank AG due to the significant debt increase warranted a shift in the competences to the general meeting was wrong; aff'd BGH (Federal Court of Justice) (7 February 2012) II ZR 253/10, (2012) ZIP 515, but the BGH did not express a final opinion on whether the case at hand is capable of falling within the *Holzmüller* doctrine because it was able to decide the case on a different legal issue; but note that the decision of the LG has received considerable support in the literature: Marcus Lutter "Der Erwerb der Dresdner Bank durch die Commerzbank – ohne ein Votum ihrer Hauptversammlung?" (2012) ZIP 351 at [4.1]–[5], where the author points out that the BGH in the *Gelantine* decisions envisaged a shift in the competences to be generally possible (provided that the *Holzmüller* threshold is satisfied) if there is an intermediating effect *or* a fundamental structural change (i.e. a change akin to one that would require an alteration of the constitution); Hans-Joachim Priester "Aktionärsentscheid zum Unternehmenserwerb" (2011) AG 654; Lutz Pospiech and Dirk Lorenz "Holzmüller Reloaded - Hauptversammlungskompetenz beim Beteiligungserwerb?" (2010) DB 1925; Habersack, above n 137, at 42, who notes that there are different opinions in the literature on the applicability of the *Holzmüller* doctrine to acquisitions of shares and supports the view that the doctrine is applicable, provided that the acquisition is not financed by an exchange of shares; Hoffmann, above n 134, at §119 [37] and [38], who advocates for using balance sheet ratios and rating methods that calculate the probability of default to determine whether the scenario satisfies the *Holzmüller* threshold; but see, for example: Dieter Leuering and Stefan Simon "Hauptversammlungszuständigkeit bei Beteiligungsveräußerung" (2007) NJW-Spezial 124; Dieter Leuering and Daniel Rubner "Ungeschriebene Zuständigkeit der Hauptversammlung – Dresdner Bank" (2010) NJW-Spezial 177; for asset deals (i.e. acquisition of assets) see Hoffmann, above n 134, at §119 [41], who argues that share deal considerations equally apply to asset deals.

[141] LG Köln (Regional Court) (23 November 2007) 82 O 214/06, (2008) AG 327 at 330, where the LG held that the *Holzmüller* doctrine was not applicable but focussed solely on the quantitative threshold; Hoffmann, above n 134, at §119 [43], who argues that a fundamental change in the structure of the AG,

3 Exceptions to the general board neutrality rule

Returning to the exceptions to the general board neutrality rule under the WpÜG, the management board of the target can engage in frustrating action, if that action is approved by the supervisory board, which is not subject to the general board neutrality rule.[142] This is despite the supervisory board being subject to similar conflicts of interest than the management board, namely the likely loss of employment (i.e. control) after the takeover.[143] In addition, the management board is able to engage in frustrating action if the action is one that "a prudent and conscientious manager of a corporation not affected by a takeover bid would have taken" or if the action is an endeavour to find a competing offer.[144]

However, these exceptions do not allow the management board to engage in frustrating action, if the frustrating action falls within the competences of the general meeting under the AktG or is otherwise prohibited by law (i.e. the WpÜG does not authorise the management board to use defensive powers that it does not have in the first place).[145] Therefore, the supervisory board, for example, cannot approve the use of a takeover defence by the management board if the decision-making authority on the implementation of such defence properly lies with the general meeting.

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warranting a shift in competences, can occur without an intermediating effect, if the sale of shares is of paramount importance for the AG, for that, the economic parameters on which the shareholders based their investment decision would change so fundamentally that a vote of the shareholders becomes necessary; Hoffmann also advocates for a flexible (lower) *Holzmüller* threshold (50–55 per cent of total assets) because the sale of shares or assets to third parties does not only have an intermediating effect but also affects the wealth of the shareholders (compare *Holzmüller*, above n 134, at 573); but see for the prevalent contrary view: Habersack, above n 137, at 43; Koch, above n 129, at § 119 [22]; LG München (Regional Court) (20 December 2018) 5 HK O 15236/17, (2019) ZIP 266 at 269, where the court's discussion of the law focuses primarily on the fundamental structural change aspect of *Holzmüller* and it is pointed out that the shareholders were able to vote on the merger anyway; BGH (Federal Court of Justice) (20 November 2006) II ZR 226/05, (2007) NZG 234, where the BGH apparently held that a sale of shares is not subject to the *Holzmüller* doctrine, even if the quantitative thresholds are met (but Hoffmann argues that on the facts the *Holzmüller* threshold was not met and that the BGH merely held that an intermediating effect was *also* not evident: Hoffmann, above n 134, at §119 [42]); for the sale of assets see Hoffmann, above n 134, at §119 [41], who argues that the *Holzmüller* doctrine applies despite § 179a to a sale of an asset that is fundamental to the AG and that the quantitative threshold should also be lower compared to *Holzmüller* at approximately 50 per cent of total assets.

[142] WpÜG § 33(1).

[143] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 27.

[144] WpÜG § 33(1).

[145] Tim Oliver Brandi "§ 33" in Lutz Angerer, Stephan Geibel and Rainer Süßmann (ed) *WpÜG: Kommentar zum Wertpapiererwerbs- und Übernahmegesetz* (3rd ed, C H Beck, Munich, 2017) at § 33 [39]; Gerner-Beuerle, Kershaw and Solinas, above n 42, at 47; and Martin Winter and Stephan Harbarth "Verhaltenspflichten von Vorstand und Aufsichtsrat der Zielgesellschaft bei feindlichen Übernahmeangeboten nach dem WpÜG" (2002) ZIP 1 at 9.

Where the decision-making authority lies with the general meeting, WpÜG § 33(2) provides that the management board can only engage in frustrating action, contrary to the board neutrality rule, with ex-ante shareholder approval.[146] However, the drafting history of WpÜG § 33(2) clarifies that WpÜG § 33(2) was not intended to limit the ability of the management board to use takeover defences that are already authorised pursuant to other laws (for example, the AktG).[147] As a result, the management board is, for example, permitted in principle to use previously authorised capital under AktG § 202 after a takeover offer has been made with the approval of either the supervisory board under WpÜG § 33(1) or the general meeting under WpÜG § 33(2).[148]

A shareholder authorisation under WpÜG § 33(2) must specify in detail the authorised action and may only be granted for a maximum term of 18 months.[149] The authorisation by the general meeting requires a majority (of votes cast at the general meeting)[150] that comprises at least 75 per cent of the capital represented at the shareholders' meeting.[151] Any action of the management board pursuant to an authorisation by the general meeting also requires the consent of the supervisory board.[152]

Although these exceptions are broad, it does not necessarily follow that the takeover defences analysed under Delaware law are available under German law.[153] The relevant takeover defences are discussed below.

B The poison pill

The poison pills used in the United States, which most commonly take the form of a "flip-in" rights plan or a "flip-over" rights plan, are not available under German law.[154]

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[146] WpÜG § 33(2).

[147] Winter and Harbarth, above n 145, at 9; BT-Finanzausschuss "Bundestag hat das WpÜG beschlossen" 14/7477 (2001) ZIP 2102 at 2104.

[148] Winter and Harbarth, above n 145, at 9; BT-Finanzausschuss, above n 147, at 2104; although as discussed below, the use of authorised capital under AktG § 202 is subject to stringent requirements that make it difficult in practice for authorised capital to be utilised as a takeover defence.

[149] WpÜG § 33(2).

[150] Note that the simple majority requirements discussed below (in the remainder of this section IV) also relate to the votes cast at the general meeting, as opposed to the total available votes: see, for example, Jan Schürnbrand "§§ 182–191" in Wulf Goette and Mathias Habersack (eds) *Münchener Kommentar zum Aktiengesetz* (4th ed, C H Beck, Munich, 2016) vol 4 AktG §§ 179-277 at § 182 [23].

[151] WpÜG § 33(2); note that the constitution may provide for a larger majority and further requirements.

[152] WpÜG § 33(2).

[153] See section III.

[154] Schlitt, above n 127, at § 33 [289].

1 Equal treatment under AktG § 53a

AktG §53a provides that "subject to the same pre-requisites being given, stockholders are to be treated equally" (the **equality principle**).[155] This is seen by the literature as generally incompatible with the classical poison pill.[156] Under the equality principle, shareholders must be treated equally but only if they are part of the same class.[157]

It is undisputed in the literature that AktG §53a is breached, if the actions at issue can be classified as *formal* unequal treatment, that is, some shareholders enjoy benefits or are subject to limitations that do not apply to other shareholders of the same class.[158] In addition, there is a widespread opinion that the equality principle also extends to *material* unequal treatment, which refers to situations where the action at issue does not, in itself, amount to unequal treatment, but that, considering the circumstances, the consequences of the action lead to unequal treatment.[159]

This principle of *material* unequal treatment is illustrated by the *Mannesmann* case, in which the BGH held that the introduction of a voting cap to impede the takeover of

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[155] AktG §53a (translation obtained from the German Ministry of Justice website: <www.gesetze-im-internet.de>); note that the equality principle cannot be disposed of by the general meeting, either generally or in regard to certain matters (only in individual cases, a shareholder may waive his or her right to equal treatment by voting in favour of the measure at issue at the general meeting): Thomas Laubert "AktG §§ 53a–57" in Wolfgang Hölters (ed) *Aktiengesetz: AktG* (3rd ed, C H Beck, Munich, 2017) at § 53a [8]; Andreas Cahn and Michael Schild von Spannenberg "AktG §§ 53a–58" in Martin Henssler (ed) *Beck OGK* (online ed, C H Beck, Munich, 1 July 2020) at § 53a [30]; and Cornelius Götze "AktG Vor § 53a, §§ 53a–56" in *Münchener Kommentar zum Aktiengesetz* (5th ed, C H Beck, Munich, 2019) vol 1 AktG §§ 1–75 at § 53a [17].

[156] Franz W Schaefer and Christian Eichner "Abwehrmöglichkeiten des Vorstands von börsennotierten Aktiengesellschaften bei feindlichen Übernahmeversuchen - ein Rechtsvergleich zwischen Deutschland und den USA" (2003) NZG 150 at 152; Schlitt, above n 127, at § 33 [288] and [289]; but see Gabriele Apfelbacher and Gerold Niggemann "AktG §§ 182–206" in Wolfgang Hölters (ed) *Aktiengesetz: AktG* (3rd ed, C H Beck, Munich, 2017) at § 192 [21], who argue that convertible bonds with change-of-control clauses (which are akin to poison pills) are permissible under German law because their main purpose is not to impede a takeover but to compensate convertible bond holders, which are not protected by law during a takeover, for the effects of a change of control.

[157] Cahn and von Spannenberg, above n 155, at § 53a [13], noting that whether shareholders are part of the same class depends on the circumstances of the case (i.e. the particular legal situation created by the relevant action).

[158] Hans Christoph Grigoleit and Richard Rachlitz "AktG § 53a" in Hans Christoph Grigoleit (ed) *Aktiengesetz: AktG* (2nd ed, C H Beck, Munich, 2020) at § 53a [15]; and Cahn and von Spannenberg, above n 155, at § 53a [26].

[159] Grigoleit and Rachlitz, above n 158, at § 53a [15], using the example of a capital decrease in the height of 10:1, the consequences of which would affect shareholders with less than ten shares significantly more than shareholders with ten or more shares because shareholders with less than ten shares would cease to be shareholders; OLG München (Higher Regional Court) (26 May 2010) 7 U 5707/09, (2010) NZG 1233 at 1234; and Koch, above n 129, at § 53a [10].

Mannesmann prima facie breached the equality principle because the voting cap, although it applied equally to all shareholders, disproportionally affected shareholders whose shareholding already exceeded the voting cap since they were unable to price in the voting restriction when purchasing the shares.[160]

The incompatibility of a classical Delaware poison pill with the equality principle derives from the fact that the pill allows all shareholders, *excluding* the bidder, to buy shares at a significant discount. Although, the poison pill treats all shareholders equally at the time it is implemented, the pill may amount to *material* unequal treatment during a tender offer because, as a *consequence* of the pill being triggered, all shareholders except one (the bidder) have the right to buy additional shares at a discount.[161]

2 Objective justification

However, the prohibition on unequal treatment under AktG §53a is not absolute.[162] Unequal treatment, whether formal or material, is permissible if there is an objective justification for the differential treatment, meaning that the measure at issue does not take the character of *arbitrary* unequal treatment.[163]

Whether the use of a poison pill by the management board can be objectively justified is doubtful. As previously discussed, the literature generally considers the poison pill to be incompatible with the equality principle. In *Mannesmann*, the court held that the voting cap was justified because it allowed the AG to defend itself from being alienated, to strengthen the independence of the management board and to protect small shareholders from the significant influence of large blockholders so as to retain the character of an AG.[164]

However, because in *Mannesmann* the voting cap was introduced by resolution of the general meeting, as opposed to by the management board, the case cannot be viewed as

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[160] BGH (Federal Court of Justice) (19 December 1977) II ZR 136/76, (1978) NJW 540 [*Mannesmann*] at 541; and Grigoleit and Rachlitz, above n 158, at § 53a [15].

[161] This also causes a disproportional dilution of the bidder's shareholding.

[162] Cahn and von Spannenberg, above n 155, at § 53a [19]; BGH (Federal Court of Justice) (9 November 1992) II ZR 230/91, (1992) ZIP 1728 at 1731; OLG München (26 May 2010), above n 159, at 1234; LG München (Regional Court) (31 March 2016) 5 HK O 14432/15, (2016) I AG 834; and Koch, above n 129, at § 53a [10].

[163] BGH (9 November 1992), above n 162, at 1731; Cahn and von Spannenberg, above n 155, at § 53a [19] and [20]; note that, generally, differential treatment is considered to be objectively justified only if it (a) is a suitable and necessary tool to give effect to the interests of the AG, meaning that the interests of the corporation should outweigh the interests of the affected shareholders, and (b) does not disproportionally limit the shareholders' rights to equal treatment: Götze, above n 155, at § 53a [15]; and KG Berlin (Higher Regional Court) (18 May 2010) 14 AktG 1/10, (2010) ZIP 1849 at 1852.

[164] *Mannesmann*, above n 160, at 541.

authority for the proposition that the introduction of a management controlled poison pill is objectively justified in the interests of the corporation, save for exceptional circumstances, such as if the takeover would represent a serious threat to the AG as a going concern.[165]

3 Convertible bonds as poison pills

Convertible bonds are the most feasible method of creating a poison pill-type defence.[166] Change-of-control clauses in convertible bonds[167] often provide for a discounted conversion price in the event of a change of control.[168] A number of DAX 30 companies have issued convertible bonds with change-of-control clauses, which appear to have a similar effect to poison pills because, if the change-of-control clause is triggered, the convertible bond holders will be able to acquire shares in the target at a discount, which is usually staggered based on when the change of control occurs.[169]

The right of conversion at a discount usually occurs after the change of control has taken place, which means that the shareholding of the acquirer will be diluted after the takeover.[170] In addition, change-of-control convertible bonds often allow the bondholder to terminate the arrangement or to require immediate repayment of the investment, which can significantly reduce the liquidity of the acquired AG (called poison debt).[171]

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[165] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 49.

[166] See Gerner-Beuerle, Kershaw and Solinas, above n 42, at 28–31 for a discussion of other (non-feasible) methods of implementing a poison pill under German law.

[167] A convertible bond is a debt security that permits the holder to surrender his or her right to repayment of the bond's nominal value in exchange for a predetermined number of shares.

[168] Falkenhausen and Klitzing, above n 130; and Apfelbacher and Niggemann, above n 156, at § 192 [21].

[169] Falkenhausen and Klitzing, above n 130, at 1513 and 1519, noting that for the change-of-control convertible bonds issued by the TUI AG, the discount is 25 per cent in year one after issuance of the convertible bond, 19 per cent in year two, 12 per cent in year three, six per cent in year four and zero per cent thereafter; see for another (more recent) example: Lufthansa Group "Shareholders pave the way for stabilization measures" (25 June 2020) Lufthansa Group Newsroom <www.lufthansagroup.com/en/newsroom>, in relation to the Deutsche Lufthansa AG, which has recently (as a result of the impact of COVID-19) issued a convertible bond to the German government that is convertible to five per cent plus one of Lufthansa's shares, which would give the German government a blocking minority of 25 per cent plus one share. However, the German government cannot exercise its conversion right, unless the government's shareholding is at risk of becoming diluted, Lufthansa defaults on its financial obligations to the government or, most relevantly, there is a takeover threat. This last condition, which allows the German government to exercise its conversion rights has striking similarities to the poison pill, although it appears that the threat of a takeover does not lead to a discounted conversion price (merely a condition for the government to be able to exercise its conversion rights).

[170] Rainer Süßmann "Unerwünschte Übernahmen" (2011) NZG 1281 at 1283.

[171] At 1283.

There are differing opinions in the literature as to whether such change-of-control convertible bonds are implemented to function as a poison pill (i.e. a defensive measure) or whether their implementation can be explained by the need for protection of convertible bond holders, which are not subject to the same protections than shareholders under the WpÜG (e.g. bid and mandatory offer provisions do not extend to convertible bond holders), against the potential effects of a change of control, such as a decrease in the credit rating.[172] In any case, regardless of whether the defensive effect of change-of-control convertible bonds is incidental or deliberate, they are not illegal under WpÜG § 33, unless they are issued after a takeover offer has been publicised.[173]

4 AktG § 221 (issuance of convertible bonds)

The issue of convertible bonds requires approval by the general meeting pursuant to AktG § 221 as well as the creation of sufficient authorised capital, which must also be approved by the general meeting and which is limited to 50 per cent of the existing share capital.[174] The issuance of the convertible bonds, independently of any requirements that apply to the creation of sufficient authorised capital, requires a majority of votes cast that comprises at least 75 per cent of the capital represented at the shareholders' meeting.[175] Usually the general meeting does not directly decide on the issuance of convertible bonds, but authorises the management board to issue the convertible bonds at some later date.[176]

In addition, if the management board intends to offer the convertible bonds to a third party, it needs to exclude the pre-emption rights of shareholders to the convertible bonds, which arise pursuant to AktG § 221(4). The general meeting must authorise the exclusion of pre-emption rights by a majority of votes cast that comprises at least 75 per cent of the capital represented at the shareholders' meeting.[177] Again, ordinarily the general meeting will authorise the management board to exclude the shareholders' pre-

[172] Apfelbacher and Niggemann, above n 156, at § 192 [21]; but see Falkenhausen and Klitzing, above n 130, at 1513 and 1519

[173] Apfelbacher and Niggemann, above n 156, at § 192 [21]; and Süßmann, above n 170, at 1283.

[174] AktG 221(1); and Brandi, above n 145, at § 33 [69]; note that the 50 per cent limit applies to increases of authorised capital under both methods outlined below (AktG §§ 192 and 202: see section IV(B)(5)).

[175] AktG § 221.

[176] AktG § 221(2); and Oliver Seiler "§ 221" in Gerald Spindler and Eberhard Stilz (eds) *Kommentar zum Aktiengesetz* (4th ed, C H Beck, Munich, 2019) vol 2 at § 221 [56], who notes that the authorisation by the general meeting cannot be given for a time period longer than five years.

[177] Seiler, above n 176, at § 221 [85].

emption rights at some later date (i.e. when the convertible bonds are issued).[178] The management board, after being authorised to issue the convertible bonds with the shareholders' pre-emption rights excluded, still requires direct authorisation from the supervisory board to issue the convertible bonds and to exclude the shareholders' pre-emption rights in each particular instance.[179]

The authorisation to exclude the shareholders' pre-emption rights to the convertible bonds issue is subject to the same requirements than an authorisation to exclude the pre-emption rights of shareholders in relation to an authorised capital increase, which are discussed in section IV(C)(2).[180] It is sufficient to note, for current purposes, that the required disclosure to the general meeting does not need to include non-essential details in relation to the terms of the convertible bonds, such as disclosing the existence of a change-of-control clause.[181]

5 AktG §§ 192 and 202 (authorised capital)

There are two regimes under the AktG for creating the authorised capital.[182] Both require a majority of votes cast that comprises at least 75 per cent of the capital represented at the general meeting.[183] Under the conditional authorised capital mechanism, which is the preferred mechanism for convertible bonds,[184] the proposal can be presented to the general meeting for authorisation at the same time than the proposal to issue the convertible bonds.[185] Contrary to the issuance of convertible

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178 At § 221 [85], noting that, although AktG § 221 does not expressly allow for an authorisation of the management board to exclude pre-emption rights at a later date, the validity of such authorisation can be derived from AktG § 203(2) and is now generally recognised in the literature: Mathias Habersack "§ 221" in Wulf Goette and Mathias Habersack (eds) *Münchener Kommentar zum Aktiengesetz* (4th ed, C H Beck, Munich, 2016) vol 4 at § 221 [173]; BGH (Federal Court of Justice) (21 November 2005) II ZR 79/04, (2006) ZIP 368 at 369; BGH (Federal Court of Justice) (11 June 2007) II ZR 152/06, (2007) ZIP 2122 at 2123; and Koch, above n 129, at § 221 [39]; but see Kaspar Frey and Heribert Hirte "Das Vorab-Bezugsrecht auf Aktien und Optionsanleihen" (1991) ZIP 697.

179 AktG § 204(1); Habersack, above n 178, at § 221 [173]; and BGH (21 November 2005), above n 178, at 369.

180 BGH (21 November 2005), above n 178, at 369; Koch, above n 129, at § 221 [39]; and see Seiler, above n 176, at § 221 [86]–[88] for a list of specific justifications in relation to a convertible bond issue without pre-emption rights that satisfy the exclusion requirements.

181 Seiler, above n 176, at § 221 [87]; and Falkenhausen and Klitzing, above n 130, at 1517.

182 AktG §§ 192 and 202; Koch, above n 129, at § 192 [9], where it is pointed out that the disadvantage of creating the authorised capital under § 202 is that such authorised capital must be renewed every five years, rendering § 202 largely unsuitable for creating authorised capital with the objective of issuing convertible bonds; and see also Seiler, above n 176, at § 221 [71]–[78], making the same point in more detail.

183 Rosengarten, Burmeister and Klein, above n 44, at 91.

184 See footnote 182.

185 Seiler, above n 176, at § 221 [68].

bonds, the general meeting cannot delegate the authority to create additional conditional authorised capital to the management board.[186]

The proposal for creating conditional authorised capital must identify, inter alia, the extent of the increase in conditional authorised capital, who can participate in the issue, which, in the case of convertible bonds, is satisfied by identifying the particular convertible bonds that are intended to provide the holder with the option to convert the bond into equity, the purpose of the increase and the issue price or the method according to which the issue price will be determined.[187]

Regarding the purpose that must be disclosed in the proposal, it is sufficient to explicitly mention that the conditional authorised capital is required to issue convertible bonds and to refer to the authorisation enabling the management board to issue bonds within the five year (maximum) period.[188] To satisfy the issue price disclosure requirement, it is sufficient to disclose a price floor, thereby leaving the final determination of the issue price to the discretion of the management board.[189]

However, pursuant to AktG § 255(2), the authorisation of the general meeting is open to challenge, if the pre-emption rights of shareholders are excluded *and* the price floor determined by the general meeting for the issuance of the convertible bonds is inappropriately low. The consideration given by the buyer is relevant for assessing the appropriateness of the issue price (especially, the lower interest/coupon rate that the buyer accepts in exchange for being able to convert the bond into shares).[190] The issue price is inappropriately low if the value of the conversion right is significantly below the average share price *at the time the capital increase was authorised* by the general meeting, which requires an assessment of what the value of the conversion right would have been if the issue occurred at the time of the capital increase.[191]

[186] Andreas Fuchs "§§ 192–201" in Wulf Goette and Mathias Habersack (eds) *Münchener Kommentar zum Aktiengesetz* (4th ed, C H Beck, Munich, 2016) vol 4 at § 192 [18].

[187] AktG § 193; Apfelbacher and Niggemann, above n 156, at § 192 [17]; and Oliver Rieckers "§§ 192–201" in Gerald Spindler and Eberhard Stilz (eds) *Kommentar zum Aktiengesetz* (4th ed, C H Beck, Munich, 2019) vol 2 at §193 [10].

[188] Koch, above n 129, at § 193 [5].

[189] Fuchs, above n 186, at § 193 [13]; this method is now commonly accepted and has been approved at the highest judicial level: BGH (Federal Court of Justice) (18 May 2009) II ZR 262/07, (2009) ZIP 1566 at 1566; the general practice is to calculate the price floor with reference to a certain percentage (e.g. 80 per cent) of the average share price of the AG during a set period (e.g. 10 trading days) before the general meeting, which authorises the conditional capital increase, convenes: Fuchs, above n 186, at § 193 [13].

[190] Fuchs, above n 186, at § 193 [16].

[191] Koch, above n 129, at § 255 [7a]; and Fuchs, above n 186, at § 193 [16].

Importantly, under the conditional authorised capital mechanism, the pre-emption rights of shareholders to the new capital are automatically excluded since shareholders are sufficiently protected through the safeguards already contained in AktG § 193.[192] However, the mechanism does not exclude the shareholders' pre-emption rights under AktG § 221(4) in respect of the convertible bonds themselves.[193]

These legal restrictions make the use of convertible bonds as poison pills difficult. The management board needs ex-ante shareholder authorisation in relation to the issuance of convertible bonds, the exclusion of shareholders' pre-emption rights and the required increase in sufficient conditional authorised capital. Although all these approvals can be obtained at once, they require a majority in votes cast that comprises 75 per cent of the capital represented at the general meeting. In addition, the management is required to make certain disclosures (especially if the shareholder's pre-emption rights under AktG § 221(4) are excluded) and the authorisations by the general meeting are required by law to determine certain parameters of the convertible bond issue, such as a price floor, which cannot be inappropriately low.

Given that the general practice is to calculate the price floor at 80 per cent of the average share price at the time of the general meeting (anything much lower may ex-post be considered by a court as inappropriately low),[194] the potency of convertible bonds as a takeover defence is further limited because a 20 per cent discount is well below the ordinary 50 per cent discount of a classical Delaware poison pill.[195]

C Equity restructuring defence

1 Placement of a block of shares with a friendly third party

The creation of authorised capital to be able to place a block of newly issued shares with a friendly third party is also possible under German law, although, again, heavily restricted. Under AktG § 202, authorised capital of up to 50 per cent of the existing share capital can be created by the general meeting for a duration of five years.[196] The mechanism for creating authorised capital under AktG § 202 is more flexible than the above discussed mechanism under AktG § 192, which is limited to certain forms of

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[192] BGH (21 November 2005), above n 178, at 369; Fuchs, above n 186, at § 192 [19]; Otto Haberstock and Georg Greitemann "§§ 221–240" in Wolfgang Hölters (ed) *Aktiengesetz: AktG* (3rd ed, C H Beck, Munich, 2017) at § 221 [67]; and Habersack, above n 178, at § 221 [217].

[193] Fuchs, above n 186, at § 192 [19]; and Rieckers, above n 187, at § 192 [18].

[194] See footnote 189.

[195] Compare section III(B)(1).

[196] Brandi, above n 145, at § 33 [67].

capital increases, such as an increase to enable holders of convertible bonds to convert their debt security into equity.[197]

As with the conditional authorised capital increase, a capital increase under AktG § 202 must be voted on by the general meeting and requires a majority of votes cast that comprises at least 75 per cent of the capital represented at the general meeting.[198] In order to use the authorised capital mechanism in AktG § 202, to place a block of shares with a friendly third party, it is necessary to also exclude the shareholder's pre-emption rights to the shares.[199]

2 Exclusion of pre-emption rights

Pursuant to AktG § 186, each shareholder "must be allotted, upon his making the corresponding demand, a portion of the new shares of stock corresponding to his portion of the current share capital".[200] However, this pre-emption right can be excluded, either as a whole or in part, in a resolution of the general meeting authorising a capital increase.[201] The resolution of the general meeting also requires a majority of votes cast that comprises at least 75 per cent of the capital represented to be effective.[202] The AktG further requires that the exclusion is "published by due and proper notice" and that the management board provides a report to the general meeting, which sets out (a) the reason for the exclusion of pre-emption rights; and (b) the reasons for the proposed issue price.[203]

The courts have supplemented these legislative requirements with additional substantive requirements.[204] These judicial requirements have, however, been loosened by the *Siemens/Nold* decision of the BGH compared to the previous position under *Kali and Salz* and *Holzmann*.[205] Under the previous position, the pre-emption rights of the shareholders could only be excluded, if, at the time of the resolution of the general meeting, specific developments, which would justify, in the objective interests of the

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[197] Compare AktG § 192(2).

[198] AktG § 202(2).

[199] Brandi, above n 145, at § 33 [67].

[200] AktG § 186(1) (translation obtained from the German Ministry of Justice website: <www.gesetze-im-internet.de>).

[201] AktG § 186(3).

[202] AktG § 186(3).

[203] AktG § 186(4) (translation obtained from the German Ministry of Justice website: <www.gesetze-im-internet.de>).

[204] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 35.

[205] Schlitt, above n 127, at § 33 [144]; BGH (Federal Court of Justice) (13 March 1978) II ZR 142/76, (1978) NJW 1316 [*Kali and Salz*]; BGH (Federal Court of Justice) (19 April 1982) II ZR 55/81, (1982) NJW 2444 [*Holzmann*]; and, for the current position: BGH (Federal Court of Justice) (23 June 1997) II ZR 132/93, (1997) NJW 2815 [*Siemens/Nold*].

AG, such an interference with the financial interests of the shareholders, were already *foreseeable*.[206] Further, at the time the management board seeks to make use of the authorisation, it will need to substantively justify the exclusion of pre-emption rights, which requires the management board to assess whether the exclusion of pre-emption rights is in the interests of the AG, suitable, necessary and proportional.[207] The decision of the management board to exclude pre-emption rights also requires the approval of the supervisory board.[208]

While the *Siemens/Nold* decision has made it easier for the management board to pass the first substantive hurdle (i.e. the requirements that apply to the resolution by the general meeting), according to the prevalent opinion in the literature, the decision does not affect the second substantive hurdle (i.e. the requirements that apply to the decision-making of the management board).[209] Moreover, AktG § 255(2) requires the management board to ensure that the issue price of shares out of the authorised capital (if the shareholder's pre-emption rights are excluded) is not inappropriately low at the time the management board makes use of the authorised capital.[210]

According to *Siemens/Nold,* it is now sufficient to disclose to the general meeting the purpose that requires the exclusion of pre-emption rights in a general and abstract form.[211] The management board, if it seeks to use the authorised capital, must ensure that the specific purpose, which has crystallised since the authorising resolution, fits within the abstract description of the purpose disclosed to the general meeting.[212] Therefore, the disclosure to the general meeting must be sufficiently precise to limit the management board's discretion.[213]

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[206] Klein, above n 22, at 2088, who criticizes that the acceptance of the courts of the possibility to distinguish between "good" and "bad" shareholders (if objectively justified in the interests of the AG) is contrary to the equality principle under AktG § 53a and the spirit of a liberal economy; but see *Kali and Salz*, above n 205; and BGH (6 October 1960), above n 22.

[207] Koch, above n 129, at § 203 [35].

[208] AktG § 204(1); and *Siemens/Nold*, above n 205, at 2816.

[209] Schlitt, above n 127, at § 33 [144]; Koch, above n 129, at § 203 [35]; and LG Darmstadt (Regional Court) (7 October 1997) 15 O 253–97, (1999) NJW-RR 1122 at 1123.

[210] Koch, above n 129, at § 203 [35]; BGH (Federal Court of Justice) (21 July 2008) II ZR 1/07, (2009) DStR 1213 at 1213; and compare section IV(B)(5).

[211] Schlitt, above n 127, at § 33 [144]; and *Siemens/Nold*, above n 205, at 2816.

[212] *Siemens/Nold*, above n 205, at 2816.

[213] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 37; BGH (21 November 2005), above n 178, at 369; Günter Reiner "Bezugsrechtsausschluss durch Hauptversammlung zu innerhalb des Unternehmensgegenstands nicht eingegrenzter strategischer Neuausrichtung („MHM Mode Holding München AG")" (2003) EWiR 301 at 301 and 302; and OLG München (Higher Regional Court) (15 May 2002) 7 U 2371/01, (2002) ZIP 1580 at 1580, where the court held that an authorisation for the strategic realignment of the AG, which allows the management board to acquire "shares and/or

Regarding the second substantive hurdle, there are different opinions in the literature as to whether takeover defences employed to defeat a tender offer (or, in other words, to preserve the current composition of shareholders) can be in the interests of the AG.[214] The opinion of *Hüffer / Koch* is convincing because it takes into account the intention of the legislator in passing the WpÜG, which was to make takeover defences more accessible.[215] According to *Hüffer / Koch*, the use of authorised capital is permissible, if it is used to defend the AG against hostile business conduct (e.g. subjecting the AG to dependency, grouping (*Konzernierung*) or destruction), but not if it is used as a defensive measure for other reasons, such as to prevent the alienation of current shareholders.[216]

In order to avoid the above requirements, the management board can protect itself by ensuring that any authorisation by the general meeting to use the authorised capital for defensive purposes also complies with the requirements under WpÜG § 33(2).[217] However, an authorisation under WpÜG § 33(2) does not alleviate the management board of its duty to consider the interests of the corporation and to assess whether in the particular situation at hand, the interests of the corporation outweigh the approved use of defensive measures.[218]

Another avenue to avoid legal uncertainty is to utilise AktG § 186, which provides for a safe harbour in relation to an exclusion of pre-emption rights, if the capital increase does not exceed 10 per cent of the existing share capital, the shares are issued in exchange for cash contributions, a stock exchange price exists for the AG's shares and the issue price is not substantially below that stock exchange price.[219] Given these

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trademarks and/or licenses and/or other assets of companies in exchange for shares in the AG" and to enter into strategic alliances, without specifying plausible reasons that demonstrate that a delegation of the authority to exclude pre-emption rights to the management board is necessary, is not sufficiently precise to satisfy the *Siemens/Nold* threshold.

[214] Schlitt, above n 127, at § 33 [145].

[215] Koch, above n 129, at § 186 [32]; and Schlitt, above n 127, at § 33 [146], who notes that, although the legislator did not expressly deal with the question of whether defensive measures can be in the interests of the corporation, its intention to make takeover defences more accessible coupled with the fact that an authorised capital increase with pre-emption rights being excluded is a common defensive measure supports the opinion that takeover defences can be in the interests of the AG.

[216] Koch, above n 129, at § 186 [32] with comprehensive references to the literature.

[217] Brandi, above n 145, at § 33 [67].

[218] At § 33 [67].

[219] Rosengarten, Burmeister and Klein, above n 44, at 91; Koch, above n 129, at § 186 [39b]; and Gerner-Beuerle, Kershaw and Solinas, above n 42, at 37; note that according to the prevailing opinion in the new literature (which is, however, contested), the adequacy of the issue price (i.e. whether it is substantially below the stock exchange price) is not to be determined by reference to a particular point in time, but

restrictions on the issue price and volume, the use of authorised capital under the safe harbour provision does not appear to be a potent defensive measure.[220]

3 Buy-back of shares

The buy-back of shares is generally permitted under the AktG. However, the management board will generally require authorisation by the general meeting, which is restricted in a similar way than an authorised capital increase (as discussed above).[221] A relevant exception to this requirement is that the management board can undertake a share buy-back *without* the authorisation of the general meeting, if the measure is necessary to avert significant and imminent damage to the AG.[222] A tender offer is not normally considered to constitute significant and imminent damage to the AG (unless, for example, a competitor places a bid with the intention to damage the AG by driving it out of the market or through asset stripping).[223] In any case, since the buy-back of shares is limited to 10 per cent of the existing share capital, this defensive measure will only be effective in combination with other defensive measures.[224]

D Acquisition and disposal defence

The power of the management board to dispose of significant assets or to acquire significant assets to impede a takeover has been discussed in great detail in section IV(A)(2), which outlines the allocation of competences between the general meeting and the management board.[225] As discussed, it is not beyond dispute whether the

instead, the inquiry is whether the management board, in accordance with its duty of care under the AktG, has set the issue price so as to ensure the best possible placement of the shares in regard to low capital raising costs and high transaction certainty: Koch, above n 129, at § 186 [39c], who notes that the usual practice is to allow for a discount of three to five per cent; and Kai-Steffen Scholz "AktG §§ 56–64" in Michael Hoffmann-Becking (ed) *Münchener Handbuch des Gesellschaftsrechts* (5th ed, C H Beck, Munich, 2020) vol 4 at § 57 [127], who argues that it is, therefore, possible to base the issue price (a) on an average stock exchange price over a certain period, or (b) on a particular point in time – the relevant reference point being the management board's decision to issue the shares (not the authorisation of the general meeting).

[220] This was demonstrated by the takeover of Hochtief AG and the Spanish construction group ACS, which successfully acquired Hochtief AG after Hochtief AG made use of authorised capital to issue shares not exceeding 10 per cent of the existing share capital to a third party in order to defend ACS's takeover attempts. This defensive measure was clearly designed to fall within the safe harbour provision, but ultimately it failed to prevent the takeover. Hochtief AG's reliance on the safe harbour provision may also indicate that it believed that the use of authorised capital beyond the 10 per cent threshold would subject it to legal challenges based on the substantive requirements established in the cases discussed above: Gerner-Beuerle, Kershaw and Solinas, above n 42, at 38 and 39.

[221] AktG § 71(1)(8); and Brandi, above n 145, at § 33 [72].

[222] AktG § 71(1)(1).

[223] Koch, above n 129, at § 71 [9]; and Brandi, above n 145, at § 33 [71].

[224] AktG § 71(2); and Brandi, above n 145, at § 33 [71].

[225] See section IV(A)(2).

Holzmüller doctrine applies to significant acquisitions or sales of shares or assets that lead to a fundamental change in the structure in the AG *without* an intermediating effect.[226]

The opinion of Jochen Hoffmann, who argues for the application of the *Holzmüller* doctrine to significant acquisitions and sales, appears most convincing because, contrary to the argument that an intermediating effect is necessary for a shift in competences between the management board and the general meeting, what really matters is whether the transaction is so significant that it would interfere fundamentally with the shareholder's membership rights and is akin to one that would require an alteration of the constitution.[227]

Therefore, the management board is limited in its discretion to dispose of or acquire significant assets or shareholdings to a threshold lying somewhere between 50 and 80 per cent of the total assets of the AG, depending on the applicable circumstances.[228] Regardless of the applicable threshold, the management board can employ this defence relatively freely, subject to approval of the measure by the supervisory board, once the tender offer has been published.[229]

E Staggered board

Due to the dual board structure, it is inevitably more difficult to remove directors from the management board. The general meeting elects members of the supervisory board for a term that is (usually) required to be no more than five years.[230] A member of the supervisory board can be dismissed early by the general meeting without cause by a 75 per cent majority of votes cast, unless the constitution stipulates a different majority or other requirements.[231] Given that members of the supervisory board can be elected for different terms (not exceeding five years), it is possible to stagger the supervisory board to slow down a change of control on the supervisory board.[232] The dismissal of supervisory board members can be complicated even further by changing the

[226] See section IV(A)(2).

[227] Hoffmann, above n 134, at §119 [35]–[42]; and see section IV(A)(2) for additional references.

[228] The 50 per cent threshold argued for by Hoffmann is the unorthodox view, which is contrary to the prevalent opinion in favour of a *Holzmüller*-like (circa 80 per cent) threshold: see section IV(A)(2).

[229] WpÜG § 33(1).

[230] AktG § 102(1); and Michael Hoffmann-Becking "AktG §§ 22–34" in Michael Hoffmann-Becking (ed) *Münchener Handbuch des Gesellschaftsrechts* (5th ed, C H Beck, Munich, 2020) vol 4 at § 30 [80].

[231] AktG § 103(1); and Schlitt, above n 127, at § 33 [284].

[232] Schlitt, above n 127, at § 33 [284].

constitution to require a majority higher than 75 per cent, although this is uncommon in practice.[233]

In addition, the supervisory board is solely responsible for the appointment and removal of directors to and from the management board. The term of office of management board members cannot exceed five years and members can only be dismissed for "grave cause".[234] A change of control is not considered to be sufficient cause for dismissal, which means that usually the bidder is required to procure a vote of no confidence by the general meeting for the supervisory board to be able to dismiss members of the management board.[235] The management board can also be staggered (subject to the five year limit) at the supervisory board's discretion, which cannot be limited in the constitution.[236]

However, compared with Delaware, the boards of AGs are not as protected as directors on staggered boards in Delaware.[237] Under AktG § 122(1), a group of shareholders representing at least five per cent of the share capital can demand the management board to call a general meeting to remove members of the supervisory board and/or to facilitate the removal of members of the management board through a vote of no confidence.[238] The management board is obliged to accept the demand without delay and in its entirety.[239]

V Takeover defences in New Zealand

A Background

After initial scepticism, New Zealand's legislature decided to introduce a strict board neutrality rule through the Takeovers Regulations 2000[240] (the **Code**), which entered into force on 1 July 2001 with the Takeovers Panel (the **Panel**) being charged with the Code's monitoring and enforcement.[241] Before the introduction of the Code, directors

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[233] At § 33 [284], noting that, in practice, the constitution usually stipulates that supervisory board members can be removed by a simple majority in votes of the present share capital.

[234] AktG 84(1) and (3).

[235] AktG 84(3); and Gerner-Beuerle, Kershaw and Solinas, above n 42, at 50.

[236] Schlitt, above n 127, at § 33 [285].

[237] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 50.

[238] Koch, above n 129, at § 122 [1].

[239] OLG Düsseldorf (Higher Regional Court) (20 December 2018) 6 U 215/16, (2019) ZIP 1112 at 1118; and Koch, above n 129, at § 122 [7].

[240] Previously called the Takeovers Code Approval Order 2000.

[241] Takeovers Act 1993, s 8(1); Tom Dibley "The Prohibition on Target Company Defensive Tactics in Takeover Situations: A Critical Examination and Options for Change" (LLM Thesis, Victoria University of Wellington, 2012) at 22 and 23.

were, however, not unconstrained in their ability to employ takeover defences. Both the Companies Act 1993 and case law placed restrictions on the defensive actions of directors, pending a takeover bid.

B The strict board neutrality rule

1 Code companies

The strict board neutrality rule, contained in r 38 of the Code, does not apply to all corporations in New Zealand.[242] Instead, it is limited to code companies, which are defined as (a) a listed issuer with financial products conferring voting rights quoted on a licensed market; (b) a corporation that used to be a listed issuer in a licensed market or such exchange during the 12 months preceding an event triggering the application of the Code; or (c) a corporation with more than 50 shareholders or share parcels.[243]

2 Prohibition on defensive tactics

Rule 38 provides that:

> If a code company has received a takeover notice or has reason to believe that a bona fide offer is imminent, the directors of the company must not take or permit any action, in relation to the affairs of the code company, that could effectively result in—
> (a) an offer being frustrated; or
> (b) the holders of equity securities of the code company being denied an opportunity to decide on the merits of an offer.

The Panel has released a guidance note titled "Defensive Tactics" that outlines the Panel's interpretation of r 38. In addition, the Panel's decisions in a number of cases, as well as academic writing, allows for the conclusion that r 38 prohibits, inter alia, the following takeover defences entirely:[244]

(a) acquiring or disposing of a major asset;
(b) incurring a material new liability or making a material change to an existing liability;[245]

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[242] Takeovers Regulations 2000, r 38.

[243] Takeovers Regulations, r 3A; Takeovers Act, s 2A; and Watts, Campbell and Hare, above n 24, at 788.

[244] Takeovers Panel *Guidance Note: Defensive Tactics* (9 September 2019) at [2.2]; *Takeovers commentary* (online looseleaf ed, Thomson Reuters) at [TC38.01] and [TK5.06]; Levy, above n 87, at 339.

[245] This could include, for example, the variation of existing contracts to include clauses that would be triggered by a takeover.

(c) declaring an abnormally large or unusual dividend or other form of capital distribution;
(d) undertaking material issues of new shares or repurchases of existing shares, or material issues of convertible securities;
(e) acquiring an asset that would render the offer subject to regulatory approval that was not anticipated by the offeror prior to the issuing of a takeover notice under r 41 of the Code;[246] or
(f) poison pills.

The Panel interprets r 38 as a strict liability provision, which does not require a finding of motivation or intention to impede or disrupt a takeover.[247] Therefore, all that is needed for an action to be classified as not allowed is that the action could *effectively* result in the takeover offer being frustrated.[248] The focus of the inquiry is on the effect of the disputed action as opposed to its purpose, which is wholly irrelevant.[249]

3 Exceptions to the strict board neutrality rule

However, the prohibition against defensive tactics is subject to three exceptions contained in r 39 of the Code. Most importantly, it is possible for directors of a target to undertake defensive tactics which have been approved by its shareholders.[250] This qualification does not permit directors to take defensive actions that are approved by shareholders retrospectively – shareholder approval must be provided ex-ante (i.e. before the action is taken but after the offer has been received).[251] In addition, the proposed resolution for ex-ante shareholder approval of a takeover defence must contain, in a form that can be readily understood by an ordinary shareholder, full particulars of the proposed action, the reasons for it and a statement explaining the significance of the resolution under the Code.[252]

Under r 39(b), a target corporation is not engaging in defensive tactics if the action is taken pursuant to a prior contractual commitment or in the implementation of a proposal previously approved by the target corporation's board.[253] Rule 39(c) provides for the prior approval of a defensive action by the Panel.[254] However, the Panel's jurisdiction

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[246] Such regulatory approval could, for example, be required under the Overseas Investment Act or the Commerce Act 1986.
[247] Takeovers Panel Determination *Otago Power Ltd* (29 May 2002) [*Otago Power No 1*] at [43].
[248] At [43].
[249] Dibley, above n 241, at 38.
[250] Takeovers Regulations, r 39(a).
[251] Takeovers Panel Determination *Otago Power Ltd* (29 May 2002) [*Otago Power No* 2] at [43].
[252] Takeovers Regulations, r 40; and *Otago Power No* 2, above n 251, at [46].
[253] Takeovers Regulations, r 39(b).
[254] Takeovers Regulations, r 39(c).

is limited to defensive actions that are unrelated to the offer and the Panel is reluctant to stand in the shareholders' shoes, which means that an application under r 39(c) must demonstrate that shareholder approval pursuant to r 39(a) is inappropriate.[255]

Forcefully arguing that an offer should not be accepted will not breach the prohibition against defensive tactics, as such conduct neither frustrates the offer nor prevents the target corporation's shareholders from deciding upon its merits.[256] The board can also encourage competing bona fide offers or enter into discussions with the offeror.[257] If the directors of the target corporation believe that it is in the best interests of shareholders, they may agree not to solicit offers from any other parties (i.e. a "no-shop" agreement) or to pay a fee (i.e. a "break fee") to the offeror in the event that the offer does not succeed.[258]

The Code is, however, not the end of the matter. First, it does not regulate conduct that occurs before a takeover is imminent or underway.[259] Second, before the Code entered into force, the conduct of directors during a tender offer was regulated through the Companies Act 1993 (the **Companies Act**), regulation and case law. Therefore, in order to compare New Zealand with Germany and Delaware and to draw conclusions on whether New Zealand should transplant law from either of those legal systems, the availability of the relevant takeover defences will be analysed as if the Code did not exist.

C The poison pill

1 Formal availability

Under the Companies Act, the board can authorise distributions (i.e. dividends), provided that the constitution of the corporation does not provide otherwise and the board is satisfied on reasonable grounds that the corporation will satisfy a solvency test.[260] The term "distribution" is defined broadly in the Companies Act and includes distributions of non-cash assets to shareholders, but does not include the issue of shares.[261]

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[255] Takeovers Panel, above n 244, at [3.11], where it is also noted that reasons such as the inconvenience or costs associated with calling a general meeting or the fact that the corporation might miss out on a business opportunity do not justify an application to the Panel under r 39(c).
[256] At [2.6].
[257] At [2.5].
[258] Takeovers Panel *Guidance Note: Lock-up Agreements* (18 September 2020) at [1.2] and [3.1]–[3.2].
[259] Watts, Campbell and Hare, above n 24, at 577.
[260] Companies Act 1993, s 52.
[261] Sections 2 and 53; and Watts, Campbell and Hare, above n 24, at 201.

However, s 54 provides that:[262]

> Subject to the constitution of the corporation, the board of a corporation may issue shares to any shareholders who have agreed to accept the issue of shares, wholly or partly, in lieu of a proposed dividend or proposed future dividends …

For the board to be able to issue shares in lieu of dividends, the shareholders must agree to accept the issue of shares, the offer must be made to all shareholders of the same class on the same terms (the **equal treatment requirement**), shareholders must be given a reasonable opportunity to accept, the rights of shareholders attaching to the shares must be maintained and s 47 (which is briefly discussed below) must be complied with.[263] Due to the reference to s 47 *and* the shares being a non-cash consideration, the board will be required to determine the reasonable present cash value of the proportion of the dividend that is distributed through the issue of shares and to resolve that it believes that such proportion is not less than the amount to be credited for the share issue.[264] Section 54 allows for the constitution to prohibit the issue of shares in lieu of dividends, but likely does not allow the constitution to modify or negate any of the requirements for an issue of shares in lieu of dividends.

The distribution of an option to purchase shares of the corporation at a later date will likely not be covered by s 53, but instead by s 54, which imposes strict requirement that must be satisfied before such a distribution can be effected. The definition of distribution in s 2 clearly excludes the transfer of the corporation's own shares from its ambit.[265] Section 54 does not expressly provide for the issue of options to purchase shares, but the section appears capable of including an issue of options to purchase shares at a future date.

However, s 54 makes it clear that the board requires ex-ante shareholder approval to issue shares (or options to purchase shares) in lieu of dividends.[266] In addition, the board must resolve, when issuing the options, that it believes that the reasonable present cash value of the proposed dividend is not less than the value of the options.[267] This requirement makes a classical Delaware poison pill unworkable as a takeover defence in New Zealand, even if ex-ante shareholder approval is obtained, because the board will in most cases not be able to issue sufficient options to credibly threaten a dilution

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[262] Companies Act, s 54.

[263] Companies Act, s 54.

[264] Section 47(1)(d); and *Companies Act commentary* (online looseleaf ed, Thomson Reuters) at [CA54.02].

[265] Companies Act, s 2.

[266] Section 54.

[267] Section 47(1)(d).

of the bidder's shareholding in a takeover. The equal treatment requirement will likely not be breached by the implementation of a poison pill because the options are granted to all shareholders and, thus, do not discriminate directly between shareholders – only non-compliance with the conditions of the options (i.e. surpassing the trigger threshold) will prevent optionholders from exercising their rights.[268]

2 Convertible securities as poison pills

Similar to Germany, a comparable effect to the Delaware poison pill may be achieved through the use of convertible financial products or options (together **convertible securities**). Under the Companies Act, the board can issue convertible securities without shareholder approval, subject to the constitution.[269] The board, however, needs to comply with s 49, which is similar to s 47 (discussed below).[270] Under s 49, the board must determine the consideration for, and the terms on, which the convertible securities and corresponding shares will be issued and resolve that it believes (subjective standard) that the consideration for, and terms of, the issue are "fair and reasonable to the corporation and to all existing shareholders".[271] The Court of Appeal has considered what fairness means for the purposes of the Companies Act, albeit focussing on a different section, and concluded that:[272]

> … the concept of fairness in the Act is one that calls for a consideration of the potentially competing interests of a corporation and its directors, a corporation and its shareholders, and shareholders themselves, but not the interests of creditors.

This statement of principle is, however, uninstructive regarding the use of convertible securities as contemplated in this paper. The requirements in the German AktG regarding a convertible bond issue can, however, provide useful guidance as to what factors may be relevant in assessing the fairness and reasonableness of a convertible bond issue.[273] Therefore, whether the issue of convertible securities with change-of-control clauses is 'fair and reasonable' may depend on the volume of the issue, whether the issue is to all or part of the shareholders or third parties, the purpose of the issue and the issue price.

[268] See Gerner-Beuerle, Kershaw and Solinas, above n 42, at 14, where the same argument is advanced in respect of the regulatory framework in the UK.
[269] Companies Act, s 42; and note that s 45 likely also applies to a convertible securities issue: see section V(D)(1).
[270] Companies Act, s 49.
[271] Section 49(1)(a) and (c); and Watts, Campbell and Hare, above n 24, at 169.
[272] *Madsen-Ries v Petera* [2016] NZCA 103, [2018] 2 NZLR 500 at [38].
[273] AktG § 193; and see section IV(B)(5).

In terms of purpose, a change-of-control clause does not inevitably lead to the conclusion that the convertible security was introduced to defeat a tender offer because it is arguable that the purpose of a change-of-control clause is to protect convertible security holders against the potential effects of a change of control, such as a decrease in the credit rating of the corporation.[274] However, this argument is not as persuasive in New Zealand as it might be in Germany because, contrary to German law, the Code requires an offer to be extended to most convertible securities.[275]

Regarding price, the issue price may be considered unfair or unreasonable if it is inappropriately low within the meaning of AktG § 255(2), which is discussed in section IV(B)(5). An issue to third parties or a particular class of shareholders may raise pre-emption issues, which will likely subject a convertible securities issue to additional scrutiny to ensure that it is fair to "*all* existing shareholders".[276] A resolution of the general meeting authorising a convertible securities issue will likely put considerations of fairness and reasonableness beyond doubt, provided that the board has provided the general meeting with sufficient information to allow for an informed decision.[277]

In summary, the use of convertible securities as a poison pill is limited in its potency due to the requirements in s 49. However, convertible securities can be issued by the board without shareholder approval, subject to the constitution allowing such issue.

3 Improper purpose doctrine

The improper purpose doctrine, which is a doctrine of longstanding heritage developed by the courts,[278] imposes restrictions on the use of takeover defences *similar* to the restrictions on defensive tactics in the Code. Section 133 of the Companies Act provides that a "director must exercise a power for a proper purpose".[279] Despite the section's troubled drafting history,[280] it is now widely accepted that Parliament did not intend to codify the director's duties, but instead to restate the common law to promote accessibility.[281]

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[274] Apfelbacher and Niggemann, above n 156, at § 192 [21]; but see Falkenhausen and Klitzing, above n 130, at 1513 and 1519.

[275] Takeovers Regulations, rr 3 and 8; and compare section IV(B)(3).

[276] Companies Act, s 49(1)(c) (emphasis added).

[277] Compare to the requirements in AktG § 193, which are discussed in section IV(B)(5).

[278] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 17.

[279] Companies Act, s 133.

[280] See Watts, Campbell and Hare, above n 24, at 552–554 for a discussion of the drafting history of s 133.

[281] *Benton v Priore* [2003] 1 NZLR 564 (HC) at [46].

The leading case on the improper purpose doctrine is *Howard Smith Ltd v Ampol Petroleum Ltd*,[282] where the Privy Council held, keeping the ratio decidendi purposely narrow, that directors cannot issue shares for the predominant purpose of turning an existing majority interest into a minority interest.[283] Lord Wilberforce, however, made some instructive observations:[284]

> it must be unconstitutional for directors to use their fiduciary powers over the shares in the corporation purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist … The right to dispose of shares at a given price is essentially an individual right to be exercised on individual decision and on which a majority, in the absence of oppression or similar impropriety, is entitled to prevail.

Howard Smith affirmed the position of the earlier Chancery judgment in *Hogg v Cramphorn Ltd*, where the court held, despite accepting that the directors were acting in good faith in what they perceived to be the best interest of the corporation, that an issue of shares, to defend a bid of a minority shareholder that the board considered unfavourably, was unlawful because it interfered with the shareholders' constitutional rights (i.e. the rights to vote and sell shares).[285] A genuine belief by the directors that what the bidder seeks to do will harm the corporation is, "even if well founded, … irrelevant".[286]

There is authority for the proposition that directors may be able in some instances to issue shares to retain control and defeat a takeover offer if the corporation is at risk of being "reduced to impotence and beggary".[287] One such example would be a bidder that seeks to obtain control of the target to run it down to lessen its competition.[288] Further, some Australian cases suggest that where the main purpose of a non-pari passu issue of shares is "to secure the financial stability of the corporation", the fact that the issue also incidentally frustrated the ambitions of a hostile bidder does not matter, even if the directors were aware of this incidental effect.[289] However, the impermissible

[282] *Howard Smith Ltd v Ampol Petroleum Ltd*, above n 23.
[283] Watts, Campbell and Hare, above n 24, at 556.
[284] *Howard Smith Ltd v Ampol Petroleum Ltd*, above n 23, at 837 and 838.
[285] *Hogg v Cramphorn Ltd* [1967] Ch 254, [1966] 3 All ER 420 (Ch) at 268; and David Kershaw "Company Law in Context: Text and Materials" (2nd ed, Oxford University Press, Oxford, 2012) at 390.
[286] *Hogg v Cramphorn Ltd*, above n 285, at 268, a case in which the directors considered that if the bidder was to gain control of the corporation this would be damaging to business and employees because the bidder had no experience of the industry: Watts, Campbell and Hare, above n 24, at 559.
[287] *Cayne & Another v Global Natural Resources PLC* [1982] Lexis Citation 569 (unreported).
[288] *Cayne & Another v Global Natural Resources PLC*, above n 287.
[289] *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 (HCA) at 493, where there was an express finding of fact that the issue of shares was not motivated by a desire to

purpose need not be dominant – it is sufficient that the "the impermissible purpose was causative [in respect of the majority of directors] in the sense that, but for its presence 'the power would not have been exercised'".[290]

Therefore, the improper purpose doctrine prohibits directors from issuing additional shares to temper with the voting control and the shareholders' ability to freely decide on whether to accept a share offer, unless the frustrating effect is incidental or the bidder seeks to reduce the target to "impotence and beggary". Since a poison pill does not have a non-defensive purpose,[291] its implementation without shareholder approval would breach the improper purpose duty in s 133. This conclusion also applies to the above considered convertible securities structure.

D Equity restructuring defence

1 Formal availability

Under s 42 of the Companies Act, the board of a corporation may issue shares at any time, to any person, and in any number it thinks fit. This power can be restricted by the corporation's constitution or may be restricted by another section in the Companies Act.[292] Section 45 provides that shareholders have pre-emption rights to newly issued shares unless the constitution specifies otherwise.[293] These pre-emption rights are commonly excluded in the constitutions of corporations, which gives directors the power to issue shares unequally.[294] However, the board's general power to issue shares is further constrained by s 47, which requires the board, inter alia, to resolve that, it its opinion, the consideration for and terms of the issue are *fair and reasonable* to the corporation and to *all* existing shareholders.[295]

In addition, the NZX Listing Rules (the **Listing Rules**) impose additional requirements on listed companies.[296] Under r 4.1.1, an issuer cannot issue equity securities without

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dilute the shareholding of the plaintiff: Watts, Campbell and Hare, above n 24, at 558; and see also *Mills v Mills* (1938) 60 CLR 150 (HCA).

[290] *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 (HCA) at [10]; *Woonda Nominees Pty Ltd v Chng* (2000) 34 ACSR 558 (NSW SC) at 563; Watts, Campbell and Hare, above n 24, at 572–574; and for the issue of different directors having different motivations: *Howard Smith Ltd v Ampol Petroleum Ltd*, above n 23, at 831 and 832; *Southern Resources Ltd v Residues Treatment & Trading Co Ltd* (1990) 3 ACSR 207 (SA SC Full Ct); and *Bell IXL Investments Ltd v Life Therapeutics Ltd* (2008) 68 ACSR 154 (Fed Ct) at [31].

[291] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 20.

[292] Companies Act, s 42.

[293] Section 45(1) and (3).

[294] Watts, Campbell and Hare, above n 24, at 555.

[295] Companies Act, s 47(1)(c).

[296] NZX Listing Rules 2020.

the approval of a simple majority of the general meeting, unless r 4.1.2 applies.[297] The general meeting must approve the precise terms and conditions of the issue and can only authorise an issue for 12 months.[298] The general meeting does not need to authorise a pro-rata issue[299] or a placement not exceeding 15 per cent of the corporation's share capital.[300] The NZX Corporate Governance Code (the **NZX Code**) also recommends (on a comply or explain basis) that pro-rata offers are the preferred method of raising additional capital.[301]

2 Share buy-back

A corporation is able to acquire its own shares, if it is expressly authorised to do so by its constitution.[302] The board has the power to make the offer, but the exercise of this power is subject to extensive constraints,[303] particularly regarding selective offers.[304] A corporation may also acquire its own shares under s 107, if it is not expressly authorised to do so in its constitution, but this requires the approval of *all* shareholders and quasi-shareholders.[305]

If the corporation is listed on a stock exchange, it may make an offer on the stock exchange for as many shares it chooses, subject to the board's resolution approving the

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[297] Rules 4.4.1 and 4.1.2.

[298] NZX Listing Rules, rr 4.2.1 and 4.2.2; note, however, that shareholder approval is not required from holders of equity securities whose terms of issue reserve the right to make the new issue, provided that such reservation discloses the maximum number, the class and timeframe within which the further issue would be made: r 4.2.3.

[299] A pro-rata issue requires that the newly issued shares are offered to existing holders so that, if the offer were accepted in full by all such holders, the proportionate voting and distribution rights of each holder would be maintained: NZX Listing Rules, r 4.3.

[300] Rules 4.3.1 and 4.5.1.

[301] NZX Corporate Governance Code 2020, rec 8.4, if the issuer raises capital by means other than a pro rata offer (e.g. placement), the issuer must explain why such capital raising method was preferred when next reporting against the NZX Code (i.e. the next annual report).

[302] Companies Act, ss 58 and 59(1).

[303] Sections 60 and 63 or 65 (note that, regardless of whether the board offers to acquire the shares pro rata or selectively, it needs to resolve, setting out its reasons in full, inter alia, that the acquisition is in the best interest of the corporation and that the terms of the offer and the consideration offered are fair and reasonable to the corporation); and Watts, Campbell and Hare, above n 24, at 205.

[304] In a selective offer, all shareholder must consent in writing *or* s 61 must be complied with, under which the board must make extensive disclosures to the shareholders and further resolve that the "acquisition is of benefit to the remaining shareholders" and that the terms and price of the offer are "fair and reasonable to the remaining shareholders", setting out its reasons in full: Companies Act, ss 60(1)(b), 61(1), 61(5) and (6) and 62.

[305] Quasi-shareholders are persons upon whom the constitution confers any of the rights and powers of a shareholder: Companies Act, s 2.

offer.[306] Under s 63, the board's resolution must set out, inter alia, providing reasons in full, the number of shares that will be acquired, that the acquisition is in the best interest of corporation and shareholders and that the terms and price of the offer are fair and reasonable to the corporation and shareholders.[307] In addition, a corporation may acquire five per cent of its own shares under a simplified regime,[308] but due to the volume restriction, a share buy-back under the simplified regime will not be a potent defensive measure.

The extensive constraints placed on share buy-backs, especially the requirements to give notice and to resolve that the buy-back is fair and reasonable and in the best interests of the corporation and its shareholders, limit the overall potency of a share buy-back as a takeover defence.

3 Improper purpose doctrine

The law as discussed above under the poison pill defence (see section V(C)(3)) is equally applicable here. While it may be argued that an issue of shares to a friendly third party or a buy-back of shares has other objectives than to defeat a tender offer, it will be difficult for the board to convince a court that "sudden non-ordinary course transactions were taken for a 'legitimate corporate purpose'" and that the interference with the tender offer was only an ancillary, non-causative, effect.[309]

E Acquisition and disposal defence

1 Formal availability

Under s 129 of the Companies Act, a corporation must not enter into a major transaction, unless the transaction is approved by a resolution of the general meeting, which requires a majority of 75 per cent of votes cast.[310] A major transaction comprises, generally speaking, an acquisition or disposition of assets,[311] the value of which is more than half the value of the corporation's assets before the acquisition or disposition.[312]

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[306] Watts, Campbell and Hare, above n 24, at 210.

[307] Companies Act, ss 63(1) and (6)–(7) and 64 (note also that before an offer is made a disclosure document must be sent to each shareholder and the offer must not be made less than 10 working days after the document was sent).

[308] Section 65; and Watts, Campbell and Hare, above n 24, at 210 and 211, where the authors note that in contrast to the other procedures, this procedure does not require the board to give reasons, to sign certificates and to give prior notice to shareholders, but subsequent notice of the acquisition must be sent to the stock exchange within 10 working days.

[309] Gerner-Beuerle, Kershaw and Solinas, above n 42, at 21.

[310] Companies Act, ss 2 and 129, subject to the constitution, which may require a higher majority.

[311] Assets include "property of any kind, whether tangible or intangible": Section 129.

[312] Section 129(2).

In addition, the Listing Rules require shareholder approval, by way of ordinary resolution (unless s 129 applies), if a transaction or related series of transactions to acquire, sell, lease, exchange or otherwise dispose of assets would significantly change, either directly or indirectly, the nature of the issuer's business, or involve a gross value above 50 per cent of the average market capitalisation of the issuer.[313] The NZX Code further recommends (on a comply or explain basis) that shareholders "should have the right to vote on major decisions which may change the nature of the issuer in which they are invested".[314]

2 *Improper purpose doctrine*

The above analysed case law applies to the *issue of shares* to defeat a takeover offer.[315] However, it is doubtful whether the improper purpose doctrine extends to other takeover defences.[316] The courts have generally declined to extend the improper purpose doctrine beyond share issues.[317] In the leading Australian case on the matter, the court held that an action taken for the dual purpose of advancing the objective interests of the corporation (which are not necessarily the same interests than those of the shareholders) and defeating a takeover are within the board's powers, provided that the action has been taken bona fide and not to preserve the positions of directors, and that it is not oppressive to the minority shareholders.[318]

The only New Zealand case on this issue also restricted the scope of the improper purpose doctrine to share issues. Prichard J in *Baigent v D McL Wallace Ltd* held that:[319]

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[313] NZX Listing Rules, r 5.1.1 (an ordinary resolution requires a simple majority of votes of shareholders entitled to vote and voting).

[314] NZX Corporate Governance Code, rec 8.3.

[315] See sections V(C)(3) and (D)(3).

[316] Watts, Campbell and Hare, above n 24, at 561–567, where the authors argue that the improper purpose doctrine should extend to other takeover defences because (a) if one accepts the shareholder primacy doctrine, only the shareholders should be able to give directors the power to interfere with their rights to sell their shares, (b) a share is designed to be personal properly that is freely transferable in the hands of the shareholder, who is entitled to accept offers from anyone, and (c) actions to impede a takeover, thus, impinge on the individual rights of shareholders as much as a defensive share issue may do, finding some support for his arguments in the following cases: *Howard Smith Ltd v Ampol Petroleum Ltd*, above n 23, at 837 and 838; *CTS Corp v Dynamics Corp of America* 481 US 69 (SC 1987) and *Criterion Properties plc v Stratford UK Properties LLC* [2002] EWHC 496, [2002] 2 BCLC 151.

[317] *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 16 NSWLR 260 (NSW CA); *Pine Vale Investments Ltd v McDonnell & East Ltd* (1983) 8 ACLR 199 (Qd SC); *Baigent v D McL Wallace Ltd* (1984) 2 NZCLC 99,122 (HC); and Watts, Campbell and Hare, above n 24, at 566.

[318] *Darvall v North Sydney Brick & Tile Co Ltd*, above n 317, at 324, 330, 335–336 and 338.

[319] *Baigent v D McL Wallace Ltd*, above n 317.

> It would, I think, be only in the most extreme case, if ever, that the Court would find that the decision of a board of directors to sell one of the corporation's assets was an abuse of power unless, of course, the directors obtained some personal advantage from the sale.

Overall, it thus appears likely that the improper purpose doctrine does not extend to acquisition or disposal transactions. Nevertheless, the use of this takeover defence is restricted by the Companies Act and the Listing Rules, although to a lesser extent than the previously considered defences.

F Staggered board

The Companies Act does not limit the duration a director may stay in office.[320] A director may be removed by an ordinary resolution of the general meeting convened on due notice.[321] A special general meeting for the purpose of removing one or more directors can be called by shareholders, regardless of whether the director(s) would be up for re-election at the forthcoming annual general meeting.[322] The constitution may determine more stringent requirements for the removal of directors,[323] which could allow for the implementation of a staggered board by opting out of the relevant default provisions in the Companies Act.

However, the implementation of a staggered board will be non-practicable for a listed corporation because under the Listing Rules "*All* directors … must be subject to removal from office by ordinary resolution".[324] An ordinary resolution can remove more than one director at once.[325] In addition, the board is obliged to call a meeting upon receipt of a written request from shareholders "holding shares carrying together not less than 5% of the voting rights entitled to be exercised on the issue".[326]

VI Comparative summary

The above discussed jurisdictions represent different points on the spectrum of takeover regulation. New Zealand has a strict board neutrality rule, whereas Delaware has no board neutrality rule at all. Germany has adopted a more balanced approach to the regulation of takeover defences by implementing a nuanced board neutrality rule, which is supplemented with the restrictions in the AktG.

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[320] But see NZX Listing Rules, r 2.7.1 (limiting the duration a director may stay in office to "the third annual meeting following the Director's appointment or 3 years, whichever is longer").

[321] Companies Act, s 156; and Watts, Campbell and Hare, above n 24, at 274.

[322] Watts, Campbell and Hare, above n 24, at 274.

[323] At 275.

[324] NZX Listing Rules, r 2.8.1.

[325] Watts, Campbell and Hare, above n 24, at 274.

[326] Companies Act, s 121.

In New Zealand, the board has broad powers, which are, however, limited by the Companies Act, the Listing Rules, the NZX Code, case law and the corporation's constitution. New Zealand's strict board neutrality rule prohibits the use of any takeover defences by the board without ex-ante shareholder approval (i.e. shareholder approval before the action is taken but after the offer has been received). If the board neutrality rule did not exist, a corporation would nonetheless be limited in its ability to employ the discussed takeover defences without ex-ante shareholder approval. The poison pill, equity restructuring and staggered board defences are subject to extensive formal restrictions, which are contained in the Companies Act, the Listing Rules and the NZX Code. While the acquisition and disposal defence is subject to less restrictions, the Listing Rules in particular limit its potency.

In Germany, the management board of an AG has broad powers ranging from the day-to-day management of the AG to making and implementing fundamental corporate policy and strategy decisions.[327] The general meeting may not give instructions to the management board, unless this is expressly requested by the management board. The broad powers of the management board have been limited by case law, such as the *Holzmüller, Kali and Salz* and *Siemens/Nold* decisions. The introduction of the WpÜG was intended by the legislator to make takeover defences more accessible, recognising that it may be in the interests of an AG to influence the composition of its shareholders.[328]

However, the restrictions in the AktG, coupled with substantive requirements introduced by the courts, limit the availability of the discussed takeover defences compared to Delaware. Nevertheless, it would be incorrect to consider German law to adhere closely to the shareholder primacy ideal. Within the relatively formulaic requirements of the AktG, the management board is able to use takeover defences, subject to the approval of the supervisory board once a takeover bid has been publicly announced.

In Delaware, the "board has a large reservoir of authority upon which to draw" and its authority is less restricted than under German or New Zealand law.[329] Delaware law, thus, provides for a relatively pure director-oriented governance system, which allows the board to play an active role during a tender offer. However, Delaware courts have been willing to impose additional requirements on directors, recognising the

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[327] Rosengarten, Burmeister and Klein, above n 44, at 83.

[328] Schlitt, above n 127, at § 33 [78].

[329] *Unocal Corporation v Mesa Petroleum Co*, above n 22, at 953.

entrenchment effect of takeover defences, through the fiduciary duties of care and loyalty that the directors owe to the corporation and its shareholders.

While the discussed takeover defences are available under Delaware law, their use in practice has declined significantly since 2000 (save for the rise of poison pills as a result of COVID-19),[330] which can be attributed to the growing shareholder activism driven by the compositional shift to institutional investors.

VII Regulatory reform in New Zealand

As concluded in section II, a balanced approach to regulating takeover defences is preferable. Therefore, New Zealand should remove the strict board neutrality rule in the Code and implement a more nuanced board neutrality rule based on WpÜG § 33(1). Given the similarities between the supervisory board and independent directors,[331] the independent directors on the board should be able to approve the use of takeover defences, provided that *all* independent directors vote in favour of the particular takeover defence at the time of its proposed utilisation. Despite the academic conflation of the roles of independent directors and the management of a corporation, the courts in Delaware have recognised these separate roles and, thus, found that, if the decision to use a takeover defence is taken by a board "comprised of a majority of outside independent directors", the proof that the board did not breach its fiduciary duties "is materially enhanced".[332]

However, it may be argued that independent directors are generally part-timers that are not as familiar with the intricacies of the corporation as executive directors,[333] which means that they are ill-equipped to make the complex decisions that are necessary during a tender offer. This valid criticism can be overcome by requiring the executive directors, who propose the use of takeover defences, to present to the independent directors a proposal outlining why a takeover defence 'is in the interests of the corporation, suitable, necessary and proportional'.[334] In addition, independent directors should, in order to discharge their duty of care,[335] obtain both financial and legal advice,

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[330] See section II(B).

[331] See section II(B).

[332] *Unocal Corporation v Mesa Petroleum Co*, above n 22, at 955; *Moran v Household International Inc*, above n 32, at 1356; *Aronson v Lewis*, above n 32, at 815; *Puma v Marriott*, above n 32, at 695; and *In re Cornerstone Therapeutics Inc, Stockholder Litigation*, above n 72, at 1186 and 1187.

[333] Wenge Wang "Independent Directors in Corporate Governance: A Comparative Study Between the US, New Zealand and China" (PhD Thesis, University of Auckland, 2014) at 146.

[334] This requirement is based on the decisions of the BGH in *Kali and Salz* and *Holzmann*, which are discussed in section IV(C)(2).

[335] Companies Act, s 137.

for example in the form of a business valuation, before approving the use of a takeover defence.[336]

An independent director, who is conflicted because the transaction involves another corporation with which the independent director has an employment or disqualifying relationship, should disclose such conflict of interest and not participate in the decision-making on whether to approve the use of a takeover defence.[337] In view of the above considerations, the following nuanced board neutrality rule (which is closely modelled on WpÜG § 33(1)) should replace the current strict board neutrality in r 38 of the Code:

> (1) If a code company has received a takeover notice or has reason to believe that a bona fide offer is imminent, the directors of the [target] company must not take or permit any action that could effectively result in the offer being frustrated.
>
> (2) This does not apply to actions which a prudent and conscientious manager of a company not affected by a takeover bid would have taken, to bona fide endeavours to find a competing offer, or to actions consented to by *all* of the (non-conflicted) independent directors on the board of the [target] company after being presented with a proposal outlining why the takeover defence is in the interests of the corporation, suitable, necessary and proportional, and after obtaining adequate legal and financial advice.
>
> (3) Subclause (1) is subject to rule 39.

Independent directors should, however, not be unrestrained in their discretion to employ takeover defences because there are potential conflicts of interest (preserving of status and salaries), as pointed out by Easterbrook and Fischel.[338] The limits placed on the authority of the board in the context of a tender offer should be *primarily* defined by

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[336] In Delaware, the courts have generally allowed directors to rely on experts when making difficult decisions and "to be 'fully protected' on the basis that they relied in good faith on qualified experts", unless certain exceptions that essentially amount to the directors acting grossly negligent apply: *Ash v McCall* 2000 WL 1370341 (Del Ch 2000) at 9; and see also *Unocal Corporation v Mesa Petroleum Co*, above n 22, at 950, 951 and 959, where the target board relied on both financial and legal advice and the court found in favour of the target board because it refused to find "that the Unocal directors have acted in such a manner as to have passed an 'unintelligent and unadvised judgment'".

[337] A disqualifying relationship "means any direct or indirect interest, position, association or relationship that could reasonably influence, or could reasonably be perceived to influence, in a material way, the Director's capacity to: (a) bring an independent view to decisions in relation to the Issuer, (b) act in the best interests of the Issuer, and (c) represent the interests of the Issuer's Financial Product holders generally, having regard to the factors described in the NZX Corporate Governance Code that may impact director independence, if applicable": NZX Listing Rules, glossary (note that the Listing Rules also include a definition of "employee").

[338] Easterbrook and Fischel, above n 18, at 1175.

legislation,[339] as opposed to case law, to avoid the uncertainty created in Delaware after the courts imposed additional restrictions on the board's authority during a takeover, which led to "a directors and officers insurance liability crisis" and an increased scarcity of qualified, disinterested directors.[340] This in turn caused the legislature to introduce a safe harbour provision for directors, allowing them (with the approval of shareholders) to exclude their liability for monetary damages, attributable to violations of their duty of care, in the corporation's constitution.[341] Given that director liability for a breach of fiduciary duties is important to restrain the board,[342] the legal position in Delaware is not desirable.

The combination of the Companies Act, the Listing Rules, the NZX Code and the improper purpose doctrine would (for the most part) place sufficient and clearly defined limits on the availability of takeover defences, if the strict board neutrality rule in the Code would be removed.[343] However, the Companies Act often relies on the concept of "fair and reasonable" in its regulation of the board's conduct, which, given the scarce case law interpreting this concept, could lead to undesirable uncertainty during a hostile bid.[344] Therefore, the Code should define criteria for assessing what is "fair and reasonable" in regard to the target board's obligations under the Companies Act during a tender offer based on AktG § 193.[345] The assessment of the "fair and reasonable" requirement (where necessary under the Companies Act) should thus be based on the volume of a defensive issue, whether the issue is to all or part of the shareholders or third parties, the purpose of the issue and the issue price (see sections IV(B)(5) and V(C)(2) for a more detailed description of these factors).

In addition to independent directors being able to approve the use of takeover defences, the Code should be amended so as to allow for ex-ante shareholder approval of takeover defences, as a safe harbour mechanism for the board, for a maximum term of 18 months.[346] Such authorisation should require a simple majority in votes cast and a

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[339] As noted in section VI, the Companies Act, the Listing Rules, the NZX Code and case law already provide extensive formal restrictions on the use of the poison pill, equity restructuring and staggered board defences, and to a more limited but non-negligible extent, the acquisition and disposal defence.

[340] *Malpiede v Townson* 780 A 2d 1075 (Del SC 2001) at 1095; and *Emerald Partners v Berlin*, above n 70, at 90.

[341] See section III(B)(3).

[342] Pinto, above n 28, at 330–333.

[343] See analysis in section V.

[344] See, for example, section V(C)(2).

[345] See sections IV(B)(5) and V(C)(2).

[346] See section IV(A)(3).

majority in share capital of 75 per cent.[347] Despite the existence of an ex-ante shareholder authorisation, the particular use of a takeover defence should still require approval by all independent directors.

The board should be required to disclose in its proposal to the general meeting, under the above mechanism, the purpose of the takeover defence in a general and abstract form (e.g. that the takeover defence is to be used for defensive purposes in times of crisis)[348] in line with the decision of the German BGH in *Siemens/Nold* (i.e. must limit the board's discretion) and the requirements that already apply under r 40 of the Code.[349] Depending on the applicable takeover defence, the general meeting should also be able to determine a price floor (for example, in respect of the issue of new shares to a friendly third party) to further safeguard the interests of the shareholders.[350]

An ex-ante shareholder approval mechanism, based on the above factors, could be achieved by amending rr 39(a) and 40 of the Code to provide for the required thresholds, the relevant disclosures and the 18-month time limit.

In addition to those safeguards, the Takeovers Act 1993 should allow shareholders to bring an action against the independent directors for compensatory damages, if no reasonable independent director in the shoes of the independent directors who have approved the use of the takeover defence would have considered that the defence is suitable, necessary and proportional based on the objective interests of the corporation (i.e. mere preference for shareholders is not sufficient, but a threat of dependency or being reduced to "impotence and beggary" may be sufficient).[351]

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[347] This requirement is based on WpÜG § 33(2), but note that this dual majority requirement is not foreign to the Companies Act, where the same majority requirements apply in regard to some insolvency regimes (for example, the compromises with creditors and voluntary administration regimes): Companies Act, s 239AK and sch 5 cl 5.

[348] For an example of times of crisis refer to the discussion of the effects of COVID-19 on takeover defences in section II(B).

[349] See section IV(C)(2); and, under r 40, the proposed resolution for ex-ante shareholder approval of a takeover defence must contain, in a form that can be readily understood by an ordinary shareholder, full particulars of the proposed action, the reasons for it and a statement explaining the significance of the resolution under the Code: Takeovers Regulations, r 40; and *Otago Power No* 2, above n 251, at [46].

[350] For example, to avoid excessive dilution of their shareholding.

[351] This requirement derives from the *Kali and Salz* and *Holzmann* decisions and was, according to the prevailing opinion in the literature, not relaxed by the *Siemens/Nold* decision; the "impotence and beggary" justification stems from *Cayne & Another v Global Natural Resources PLC*: see section V(C)(3); and, given the recommended disclosure requirements in relation to the executive directors presenting a proposal to the independent directors and the requirement for independent directors to obtain financial and legal advice, this personal liability provision should not be too onerous for independent directors.

This course of action should be provided for in subpart 2 of part 3 of the Takeovers Act 1993 and s 33L should apply to any compensatory order that a court may make under such provision. The threat of liability would ensure that independent directors exercise their discretion carefully, similar to the limitations placed on the management board in Germany regarding the use of authorised capital under the exclusion of pre-emption rights,[352] to prevent the directors from acting for improper (self-preserving) motives.

VIII Conclusion

The purpose of this paper was to provide a framework for law reform in New Zealand in relation to the strict board neutrality rule contained in the Code. This framework for law reform, the need for which was identified in section II with reference to the director primacy theory and the more recent empirical evidence on the value-creating effects of takeover defences, is based on the law on takeover defences in Delaware and Germany. These jurisdictions were analysed in sections III and IV with a focus on the poison pill, equity restructuring, acquisition / disposal and staggered board defences.

The analysis of the regulatory environment in New Zealand regarding takeover defences in section V demonstrates that, even in the absence of a strict board neutrality rule, the board's discretion to use one of the above defences is limited. It is, therefore, recommended that New Zealand adopts a nuanced board neutrality rule (similar to the rule in the WpÜG), which allows independent directors to approve the use of takeover defences, provided that these defences are not otherwise prohibited. The recommended board neutrality rule also allows for ex-ante shareholder approval of takeover defences for a maximum term of 18 months.

[352] See section IV(C)(2) (specifically, the opinion of *Hüffer / Koch*).

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