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COVID, Crisis, and Corporate Control: The Case for Takeover Defences in New Zealand

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Abstract

This paper examines New Zealand's no frustration rule regarding hostile takeover bids in the context of an economic crisis. It considers the impacts of COVID 19 on markets for corporate control and argues that COVID 19 has increased the risk of opportunistic hostile takeovers. It further argues that the context of an economic crisis undermines the economic arguments for the no frustration rule. It also examines the principle of shareholder sovereignty and suggests that the need to protect the interests of companies, shareholders, and stakeholders outweigh that principle in times of crisis. It argues that alternatives to allowing exceptions to the rule do not fully address the new challenges caused by this crisis. It concludes that the most effective way to balance the competing interests is to reform the law to allow the Takeovers Panel to permit the use of defences for proper purposes during times of economic crises.

Keywords: Takeovers, COVID, Defences

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I Introduction

Whether managers and directors should be able to block takeover bids is a keenly debated issue in corporate governance policy. On the one hand there are those who claim takeovers are beneficial to the economy. On the other are those who argue managers should have the necessary power to protect the interests of their company. Others still suggest that as a matter of principle the decision should lie with shareholders. In New Zealand, this debate has traditionally skewed heavily against managerial intervention. However, in light of the COVID 19 economic crisis and its implications for financial markets, these arguments merit fresh consideration.

The market for corporate control, commonly referred to as the takeover market, is traditionally viewed value-creating. Corporations which use resources inefficiently or are managed ineffectively will suffer a decrease to their share price as a result. Takeover threats disincentivise these inefficiencies. If inefficiencies persist, the acquirer will in theory be able to purchase the company's shares at a discount and remedy those inefficiencies in pursuit of profit.[1] Through these mechanism takeovers can promote economic efficiency, by optimising resource allocation and reducing managerial self-dealing, and generate value for companies and their shareholders.[2] Even in efficiently run companies, some suggest takeovers can generate value by improving productive efficiency.[3] Takeovers are also seen as upholding shareholder sovereignty. According to this principle shareholders should have the right to decide when and to whom to sell their shares without management intervention.[4]

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[1] Michael C Jensen, Richard S Ruback "The Market for Corporate Control: The Scientific Evidence" (1983) 11 Journal of Financial Economics 5.

[2] Chris Hare *Company Law in New Zealand* (2nd ed, LexisNexis, Wellington, 2016) at 782; David Kershaw "Principles of Takeover Regulation" (Oxford University Press, Oxford, 2016); Jensen, above n1.

[3] Sayan Chatterjee "Sources of Value in Takeovers: Synergy or Restructuring – Implications for Target and Bidder Firms" (1992) 13 Strategic Management Journal 267.

[4] 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, LSE Law, Society and Economy Working Papers 3, 2011) at 3.

For these reasons many jurisdictions, including New Zealand, have implemented some form of a 'no frustration' rule.[5] Broadly speaking, these types of rules prevent the managers and directors of a company targeted by a takeover bid from taking or authorising actions which would frustrate said bid.[6] In a friendly takeover where the target company's board supports the bid, this rule is something of a moot point. It is only engaged when the takeover is hostile, and the target company's directors do not support an offer made to their shareholders. In absence of a 'no frustration' rule those directors may be able to effectively block that bid though the use of defensive tactics. The crown jewels or asset divesture defence for instance involves selling off or threatening to sell off key assets to discourage a takeover bid.[7] Another popular defence, the poison pill, involves issuing options to existing shareholders which trigger when a bidder acquires a certain percentage of the company's shares.[8] When this occurs, all shareholders except the triggering shareholder may purchase shares in the company at significant discount, making it much costlier for the bidder to acquire a controlling interest in the company.[9]

This view of takeovers as valuable, however, is not universally accepted. Many have argued that the economic benefits of takeovers, in relation to resource allocation, agency costs, and value generation, are overstated.[10] The value generation argument has been criticised for overlooking concerns that the value generated in a takeover may be the result of wealth transfers.[11] The claim that takeover threats can discipline management has been questioned for relying on managerial inefficiency and the resulting agency costs as being the primary motivator for decreases in share price.[12] Even from a principles standpoint,

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[5] Takeovers Regulations 2000, r 38 ("Takeovers Code").
[6] Rule 38.
[7] Gerner-Beuerle, Kershaw and Solinas, above n4, at 10.
[8] At 7.
[9] At 7.
[10] See for example: John Coffee "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 CLR 1145.
[11] Paul Davies "Controls Shifts via Share Acquisition Contracts with Shareholders (Takeovers)" in Jeffrey N Gordon and Wolf-Georg Ringe (eds) *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press, Oxford, 2018) 532.
[12] Coffee, above n10.

shareholder sovereignty is seen by some as myopic and conferring too much power to shareholders which may actively harm their interests and others'.[13]

COVID 19 and the resulting economic crisis has further complicated the issue. This once in a century pandemic has, among other things, thrown financial markets into disarray and cast doubt on many assumptions underlying the rationales in favour of the no frustration rule. With the sudden and dramatic downturn in the markets, many companies' stock prices are plummeting prompting comparisons to the '08 global financial crisis.[14] In the context of hostile corporate takeovers, the present economic crisis exacerbates many of the problems highlighted by critics of the 'no frustration' rule. Some are warning that the severely reduced prices of shares, relative to what they would have been worth pre-crisis, will leave corporations vulnerable to opportunistic hostile takeovers.[15]

This paper will examine each of the arguments advanced in favour of the 'no frustration' rule. It will consider whether each of those arguments is supported and whether, during the COVID 19 economic crisis, those arguments need to be qualified. It will then consider whether legal reform is necessary to balance the competing factors and what form those reforms might take. Part two will describe the problem that is the focus of this paper. It will provide a brief overview of New Zealand's legal regime for regulating the use of takeover defences. It will then consider the effects of COVID 19 on stock markets and how those effects potentially leave some corporations exposed to a greater risk of hostile takeover. Part three will examine the claims that corporate takeovers, and by extension the 'no frustration' rule, are inherently valuable. It will consider whether takeovers can promote efficient resource allocation, reduce agency costs, and actually generate value for companies and their shareholders. Based on the evidence it examines whether the value of

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[13] Lars Klöhn "Preventing Excessive Retail Investor Trading under MiFID: A Behavioural Law & Economics Perspective" (2009) 10 EBOR 437.

[14] 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/2020/05/04/blood-in-the-water-covid-19-ma-implications/>.

[15] Paul Shim, James Langston and Charles Allen "Rewriting the Poison Pill Prescription: Consider Active Defences During COVID-19" (5 April 2020) Harvard Law School Forum on Corporate Governance <https://corpgov.law.harvard.edu/2020/05/04/blood-in-the-water-covid-19-ma-implications/>.

takeovers, especially in the context of an economic crisis, is overstated. It will also consider the principle of shareholder sovereignty and the extent to which that sovereignty should be balanced against both shareholder and stakeholder interests. Part four will discuss additional benefits of takeover defences including increased managerial bargaining power, greater stakeholder protection, and the suggestion that defences can increase the long term value of a company. It will consider whether these claims are supported and whether the evidence supports allowing the use of takeover defences. Part five will explore alternative methods of addressing the increased risk of hostile takeovers by examining how Australia and the UK have responded to the crisis and their similarities to New Zealand's own response. It will also compare those responses, based in legislation, to the US response which has been characterised by a rapid uptake of takeover defences. Part six will argue that legal reform is needed in New Zealand to ensure effective protection is available to companies where managers are acting legitimately in response to the increased risk of hostile takeover arising as a result of COVID 19. It will consider two potential strategies, one which would require companies to get approval from the Takeovers Panel before implementing defensive strategies (the ex-ante strategy) and the other a US-style approach which would allow defences subject to review by the Courts (the ex post strategy). Part seven will conclude and argue that during an economic crisis the value of takeovers is overstated. It suggests that the importance of the shareholder sovereignty principle needs to be carefully balanced against competing concerns. Allowing the use of takeover defences in limited circumstances is the most effective way to enable corporations to protect themselves from crisis driven hostile takeover threats.

II COVID and Corporate Control in New Zealand

A New Zealand Takeover Regulations

New Zealand has two separate sets of rules for regulating takeovers. The first regime which applies to companies not covered by the Takeovers Code is contained in the Companies

Act, and the common law.[16] This largely covers unlisted companies and companies with fewer shares.[17] The second regime, and the one which this paper is primarily concerned with, is based heavily on that of the UK.[18] This approach empowers a body formed of industry professionals to create and enforce takeover regulations and is intended to address the potential unfairness arising from voting power in widely held companies becoming overly concentrated.[19] The regime has three key components including the Takeovers Act (the Act)[20], the Takeovers Panel (the Panel), and the Takeovers Code (the Code)[21]. The Takeovers Act establishes and empowers a Takeovers Panel to formulate, recommend, review, administer, and enforce a Takeovers Code.[22] This Panel is formed of between five and 11 members.[23] One of these must be a barrister or solicitor with at least seven years of experience.[24] Other members must be qualified or experienced in business, accounting, or law.[25] The Panel is responsible for, amongst its other functions, reviewing and recommending changes to the Takeovers Code.[26] The Code is primarily concerned with limiting the acquisition of voting rights in 'code companies'.[27] These include publicly listed companies, some previously listed companies, and companies with at least 50 shareholders or share parcels and at least 30 million dollars of assets or 15 million dollars of revenue.[28] No individual or group of associates may hold more than 20 per cent of a code company's voting rights, which due to dispersed holding and difficulties exercising

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[16] Companies Act 1993; Andrew Beck, Andrew Borrowdale, Nicola Buchegger, Neil Campbell, Paul Foley, David Goddard, David Jones, Simon McArley, Mandy McDonald, Richard Gordon, Giora Shapira, Michael Walls and Peter Watts "Morisons Company Law (NZ)" (online ed, LexisNexis) at [43.1].

[17] Beck, Borrowdale, Buchegger, Campbell, Foley, Goddard, Jones, McArley, McDonald, Gordon, Shapira, Walls and Watts, above n16, at [43.1].

[18] Tom Dibley "The Prohibition on Target Company Defensive Tactics in Takeover Situations: A Critical Examination and Options for Change" (LLM Research Paper, Victoria University of Wellington, 2012) at 22; (17 December 1991) 521 NZPD 6351.

[19] Hare, above n2, at 781-782.

[20] Takeovers Act 1993.

[21] Hare, above n2, at 784.

[22] At 784; Takeovers Act.

[23] Section 6(1).

[24] Section 6(3).

[25] Section 6(4).

[26] Section 8(1)(a).

[27] Takeover Regulations, r 6(1).

[28] Rule 3A.

voting rights would grant them 'practical control' of the company, unless they follow the processes set out in the Code.[29] More importantly for the purposes of this paper, rules 38 and 39 of the Code form an effective prohibition on the use of takeover defences.[30]

The 'no frustration' rule is contained in rule 38 of the Code. Once a takeover notice has been issued or there are reasonable grounds to believe a bona fide offer is imminent the target company's directors may not take or permit any defensive actions.[31] This prohibition is not limited to traditional defensive measures such as asset divestitures and poison pills. It includes any action which may frustrate a bid or deprive shareholders of a chance to decide whether to accept an offer on its merits.[32] The Panel has interpreted the prohibition broadly and determined that it may be violated by refusing or delaying provision of certain necessary information[33], refusing to register share transfers[34], or any action which may trigger defeating conditions in the offer[35]. However, r 38(2) explicitly permits directors to seek or encourage competing bona fide offers from other persons or companies, commonly referred to as white knights.[36] These actions are permitted despite their potential to frustrate the initial bid.[37] The Panel has indicated that when determining whether an action contravenes rule 38 intent is not relevant, only the potential consequences of the action.[38]

Rule 39 permits defensive actions in three types of situation. Firstly, rule 38 does not apply if the relevant defensive action has been approved by an ordinary shareholders' resolution.[39] This exception only permits defences when a majority of shareholders have decided not just to reject an offer, but that there is some reason to prevent other shareholders

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[29] Hare, above n2, at 779; Takeovers Regulations, rr 6 – 7.
[30] Takeovers Regulations, rr 38 – 39.
[31] Rule 38.
[32] Rule 38.
[33] Takeovers Panel "Defensive Tactics" (Guidance Note, September 2019), at 2.2.
[34] Takeovers Panel *Otago Power Ltd* (17 May 2002).
[35] Beck, Borrowdale, Buchegger, Campbell, Foley, Goddard, Jones, McArley, McDonald, Gordon, Shapira, Walls and Watts, above n16, at [43.16].
[36] At [43.16]; Takeovers Regulations, r38.
[37] Takeovers Regulations, r 38.
[38] Takeovers Panel, above n34.
[39] Takeovers Regulations, r 39.

accepting it. Importantly, under this exception, the decision to 'frustrate' a bid remains in the hands of shareholders.[40] In situations of economic crisis, where some shareholders may be tempted by the opportunity to cash out at above market rates, this exception may provide some defence if the majority of shareholders determine that accepting the offer in not in their or the company's best interests. Secondly, rule 39 excludes actions which arise from contractual obligations entered into or proposals approved by directors prior to the company becoming aware that an offer was 'imminent'.[41] This might allow companies, for instance, to execute a contract for the sale of a key asset they had entered into before a bid became imminent or implement a prior board approved strategy which may violate the prohibition. Finally, the Panel can approve actions which may amount to defensive tactics under rule 39(c) unless the purpose of the action is to frustrate a takeover.[42] Both the Act and the Guidance note from the Panel state that such actions may be approved only where they can be shown to be 'unrelated' to the offer.[43] However, the Panel has indicated a reluctance to stand in the shoes of shareholders so the company would need to show good reason why convening a shareholders meeting to approve the action would not be appropriate.[44] This is a high threshold and the cost of convening such a meeting or the risk of missing out on a large commercial opportunity are not sufficient justifications.[45] As a result this exception is unlikely to be engaged.

B COVID and Corporate Control

It is difficult to say how COVID 19 will affect financial markets in the longer term. Early impacts however merit some concern. With border closures, lockdown measures, reduced economic activity, and increased unemployment, COVID 19 has triggered such massive declines in financial markets that some have drawn comparisons to the 2008 global

[40] Takeovers Regulations, r 39.
[41] Takeovers Panel, above n33.
[42] Takeovers Regulations, r 39(c).
[43] Takeovers Panel, above n33.
[44] Takeovers Panel, above n33
[45] Takeovers Panel, above n33.

financial crisis.[46] There are some exceptions to this, for instance large tech companies including Amazon, Zoom, and Netflix who have increased in value possibly due to lockdown measures increasing the popularity of their services. For the vast majority of businesses however, the effects of COVID 19 can be broadly described as alarming.[47] In New Zealand, the Treasury's March Economic indicators show significant disruption to financial markets.[48] AMP Capital reported massive declines in stock market prices driven by increased uncertainty arising from COVID 19.[49] Travel and tourism businesses have been some of the hardest hit with at least two New Zealand travel agents, one with a Swiss parent company, having declared bankruptcy since COVID began in 2020 as a result of border closures.[50] Even as the first wave of COVID 19 has been weathered by many countries signs of resurgence can be seen in New Zealand.[51] Experts are warning that where it has yet to happen, the second wave constitutes an 'imminent threat' from both the public health and economic perspectives.[52]

In the context of takeovers, the declines in share prices caused by COVID 19 can greatly increase the risk of hostile takeover bids. In a paper released in March, the Organization for Economic Cooperation and Development (OECD) noted that high corporate indebtedness, difficulty obtaining financing, and an overall reduction in market liquidity

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[46] Araujo, Massoud and Papadopoulos, above n14; Tom Stannard, Gregorius Steven and Chris McDonald *Economic impacts of COVID-19 containment measures* (Reserve Bank of New Zealand, AN2020/4, May 2020) at 4.

[47] Robin Wigglesworth "How Big Tech got even bigger in the COVID-19 era" *Financial times* (Online ed., Oslo, 2 May 2020).

[48] The Treasury *Monthly Economic Indicators March 2020* (The Treasury, 9 April 2020).

[49] Daniel Mead "Impact of COVID-19 on domestic share market" (23 March 2020) AMP Capital <https://www.ampcapital.com/nz/en/insights-hub/articles/2020/march/impact-of-covid-19-on-domestic-share-market>.

[50] Amelia Wade "Holiday warning as travel agencies go bust, leaving hundreds without tickets" *The New Zealand Herald* (Online ed., New Zealand, 21 Jan 2020); Amanda Cropp "STA Travel Group insolvency causes chaos for young travellers" *Stuff* (Online ed., New Zealand, 26 August 2020).

[51] Marc Daalder "The NZ strains: Our second wave" *Newsroom* (Online ed.. New Zealand, 6 October 2020).

[52] Giacomo Cacciapaglia, Correntin Cot and Francesco Sannino "Second wave COVID-19 pandemics in Europe: a temporal playbook" (2020) 10 Sci Rep 15514.

caused by COVID 19 have led to increased volatility in financial markets.[53] The European law firm Noerr LLP noted that high market volatility and valuation uncertainty may cause companies share prices to be underrated on stock markets relative to their 'true value'.[54] These effects have also been observed in New Zealand.[55] What is crucial here is that these declines in share prices do not appear to be driven by poor corporate performance but rather by, ostensibly temporary, external factors and market sentiment. The problem, in other words, it is that the cascade of social and economic consequences of this pandemic has created a risk of companies' shares being severely undervalued. This could potentially make companies subject to that undervaluing more attractive targets for well capitalised investors. Furthermore, the increased volatility from COVID 19 may incentivise risk-adverse investors to sell off shares by making even small premiums offered on takeover bids all the more attractive.[56] Together these factors create an environment ripe for opportunistic hostile takeovers.

Further evidence of the threat posed by COVID 19 can be seen in corporate and governmental responses to the pandemic around the world. The UK, Australia, and New Zealand have all passed new law or regulations to enable them to better scrutinise investment from foreign entities and prevent opportunistic hostile takeovers of domestic businesses.[57] Many of these reforms focus on preventing foreign investors from acquiring large shareholdings in businesses important to national interests.[58] In the US, companies

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[53] OECD "Global financial markets policy responses to COVID-19" (March 2020) OECD <http://www.oecd.org/coronavirus/policy-responses/global-financial-markets-policy-responses-to-covid-19-2d98c7e0/>.

[54] Noerr LLP "Public Takeovers during the COVID-19 Pandemic" (press release, 22 April 2020).

[55] Mead, above n49.

[56] Daniel Kahneman and Amos Tversky "Prospect Theory: An Analysis of Decision under Risk" (1979) 41 Econometrica 263.

[57] Department for Business, Energy & Industrial Strategy and Alok Sharma "New protections for UK businesses key to national security and fight against coronavirus" (press release, 21 June 2020); Michael French, Martin Irwin and Michelle Ralston "Australia: Foreign investment temporary measures in response to COVID-19" *Mondaq* (online ed, Australia, 9 May 2020); Laura Walters "Protecting against China's post-Covid buying spree" *Newsroom* (online ed, New Zealand, 29 June 2020).

[58] Department for Business, Energy & Industrial Strategy and Sharma, above n57; French, Irwin and Ralston, above n57; Walters, above n57.

have rushed to adopt antitakeover measures with the poison pill gaining a recent surge in popularity.[59] This general reaction shows a recognition of the increased takeover threat arising from the recent economic downturn.

III The Case for the 'No Frustration' rule

In order to determine whether the 'no frustration' rule is a necessary part of New Zealand's regulatory regime it is instructive to examine why the rule was initially implemented. While the rule does not appear to have been discussed by the New Zealand legislature in great detail, some rationales can be inferred from advisory reports written around the time the Code was created. The Securities Commission, when considering whether to recommend a 'no frustration rule' noted takeovers' ability to optimise resource allocation and discipline management.[60] They also noted complaints of target companies unfairly frustrating offers or being too 'locked up' for offers to be made.[61] The Panel cited similar reasons for recommending a 'no frustration' rule be included in the Code.[62] According to the Panel's 1995 report takeovers are a valuable tool for disciplining management and maximising resource allocation efficiency.[63] These arguments tie into a broader justification advanced for the 'no frustration' rule which views takeovers as value generating even in absence of inefficiencies.[64] Echoing some complaints highlighted by the Securities Commission, the Panel noted that defensive tactics are an impediment to the smooth operation of takeover markets.[65] Based on these observations it appears that takeovers are seen as valuable for promoting economic efficiency. The no frustration rule therefore appears to be justified as facilitating those takeovers.

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[59] Ofer Eldar and Michael Wittry "The Return of Poison Pills: A First Look at "Crisis Pills"" (6 May 2020) Harvard Law School Forum on Corporate Governance <https://corpgov.law.harvard.edu/2020/05/06/the-return-of-poison-pills-a-first-look-at-crisis-pills/>.

[60] Securities Commission *Company Takeovers: Report to the Minister of Justice by the Securities Commission* (Commerce Clearing House, October 1988) at 193.

[61] At 191.

[62] Takeovers Panel *Report of the Takeovers Panel on the Takeovers Code* (June 1995) as cited in Hare, above n2, at 782, footnote 23. Note: The author of the present paper was unable to find this report.

[63] Takeovers Panel, above n62.

[64] Donald G Simonson "Value in hostile takeover attempts" (1990) 100 United States Banker 66.

[65] Dibley, above n18, at 20.

Upholding shareholder sovereignty is another potential reason for the 'no frustration' rule. This can be inferred from past Court decisions and the Code itself. According to this principle, the decision of whether or not to sell their shares should ultimately be made by shareholders.[66] Takeover defences therefore violate a core right of shareholders as they allow directors to more or less decide which offers should be considered. New Zealand has historically demonstrated a strong adherence to this principle. In the context of determining whether an issue of shares as a takeover defence should be considered an improper exercise of a power the New Zealand High Court indicated approval, albeit in obiter, for the Australian approach in *Howard Smith v Ampol Petroleum*.[67] *Howard Smith* suggested that courts will look to the true or main purpose for an action in determining whether it is improper.[68] In *Howard Smith* the Court held that actions taken "for the purpose of shifting the power to decide to whom and at what price shares should be sold" cannot be a legitimate exercise of the powers conferred to directors.[69] The Court also cited *Hogg v Cramphorn* where the UK High Court stated that it would not permit directors' powers to be exercised in a way which would "interfere with the exercise by the majority [of shareholders] of its constitutional rights".[70] This was despite the Court accepting that at all times the directors had acted in the company's best interests.[71] Given that one of the objectives of the Takeovers Act is to align New Zealand's law with that of Australia it is likely the *Howard Smith* approach would have been followed had the Code not been implemented.[72] This line of cases suggests that even without the Code New Zealand Courts would likely uphold the shareholder sovereignty principle. That principle is also reflected in the Code itself. Rule 38 which prohibits defences expressly allows directors to seek a white knight so long as shareholders are not "denied an opportunity to decide on the merits of an offer".[73]

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[66] Gerner-Beuerle, Kershaw and Solinas, above n4, at 3.
[67] Companies Act, s133; *FXHT Fund Managers Ltd (in Liq.) v Oberholster* HC Whangarei CIV-2007-488-000285, 9 April 2008 at [36].
[68] At [36].
[69] *Howard Smith Ltd v Ampol Petroleum Ltd and Ors.* [1974] 48 ALJR 5 (PC) at 10.
[70] *Hogg v Cramphorn Ltd and Ors.* [1963] 1 Ch 254 at 268.
[71] At 265.
[72] (17 December 1991) 521 NZPD 6351; Takeovers Act, s 24.
[73] Takeovers Regulations, r 38.

Furthermore rule 39, which allows a majority of shareholders to authorise defensive actions, seems to reflect the historic common law view that only shareholders should be able to decide whether an offer should be accepted.[74] Both the Code and historic common law seem to suggest that in New Zealand shareholder sovereignty is an important influence on takeover regulations and could be another justification for New Zealand's 'no frustration' rule.

A The Economic Arguments

Two key economic arguments have been advanced in favour of a no frustration rule in New Zealand.[75] Firstly, an active market for corporate control, and therefore prohibiting impediments to that market's functioning, can improve resource allocation efficiency in the economy.[76] Secondly, the market for corporate control is a useful tool for managing agency costs between management and shareholders.[77] This relies on the threat of a takeover, and subsequent removal from office, to disincentivise managerial self-dealing and incompetence.[78] While these arguments have considerable support, they also face extensive criticism. Furthermore, the context of an economic crisis calls the validity of some of these arguments into question.

1 Resource Allocation

A key argument in favour of the 'no frustration' rule views hostile takeovers as a way of promoting more efficient resource allocation.[79] If a company is using resources inefficiently this inefficiency should in theory reduce the company's profitability. This reduces its share price making the company cheaper for potential bidders to acquire.[80] When the discount for inefficiencies is sufficiently high, acquirers have an opportunity to

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[74] Takeovers Regulations, r 39.
[75] Takeovers Panel, above n62; Securities Commission, above n60.
[76] Takeovers Panel, above n62.
[77] Davies, above n11, at 541; John Armour, Henry Hansmann and Reinier Kraakman "Agency Problems and Legal Strategies" in Reinier Kraakman, (ed) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd ed, Oxford University Press, Oxford, 2017) 29 at 34.
[78] Davies, above n11, at 541.
[79] Davies, above n11, at 541; Takeovers Panel above n62
[80] Hare, above n2, at 782.

make a profit by taking over the company, utilising resources more efficiently, and increasing the company's profitability. This makes the company an attractive target for a takeover bid. Although the primary motive may be to make a profit, the acquirer also helps to maximise resource allocation efficiency. This in turn can create value for the company and for shareholders. More efficient resource allocation can also improve overall economic efficiency. A study into the sources of value in a takeover found indirect support for this argument.[81] According to that study, takeovers can increase the value of a target company by highlighting opportunities previously either not known to or not pursued by that target.[82] However, some commentators have challenged this argument.[83] Specifically those which found a large number of instances of well run and efficient companies being subject to takeover bids.[84] This seems to suggest that, in some cases at least, takeovers are not driven by inefficient resource allocation.

Certain types of investor commonly referred to as activist investors, vulture investors, or corporate raiders, are another exception to the assumptions underlying the resource allocation argument. In order to achieve a short term profit from a takeover these investors may target companies whose market value is below what its assets are worth.[85] Such investors can purchase controlling stock in said company to force it to sell off its assets to realise a rapid gain.[86] These tactics can hardly be said to improve resource allocation efficiency. With the downturn in markets caused by economic crises such as COVID 19, the risk of a company's stock price not reflecting its value is greatly increased and as a result so is the risk of an opportunistic takeover by this type of investor.

Another criticism of the resource allocation argument is the assumption that reduced market value and therefore hostile takeovers will be driven to a significant extent by an

[81] Chatterjee, above n 3.
[82] Chatterjee, above n3, at 284.
[83] Bob Dugan "Law, Economics and the Draft Takeovers Code" (1996) 26 Victoria U Wellington L Rev 39 at 53-54.
[84] At 53.
[85] See for example: Riva Atlas "The lone raider rides again" (1997) 31 Institutional Investor 42.
[86] See for example: Atlas, above n85.

inefficient use of resources.[87] During an economic crisis there is a very real risk that companies will be undervalued relative to their 'true value' in a pre-crisis market.[88] The concern is that in such circumstances a takeover bid will be driven by this 'crisis discount' rather than the company's underlying inefficiencies. Given the risk of undervalue, this concern might be dismissed by saying that no rational investor would sell their holdings in such circumstances, however studies suggest investors are subject to a variety of cognitive biases. These include the anchoring and loss aversion biases, which will be discussed later in more detail, which may be exploited to motivate them to sell.[89] These biases appear to affect the behaviour of retail and institutional shareholders alike.[90] The depression in value means that even very efficient companies can be left vulnerable to takeover. Therefore 'improving resource allocation efficiency' potentially does not factor into hostile takeovers driven by undervaluing in times of economic crisis.

2 Agency Costs

An efficient market for corporate control, and by extension the 'no frustration' rule, is said to play an important role in reducing agency costs.[91] These can arise where management, who have been delegated power by shareholders to run a company, reduce a company's value by misusing those powers to self-deal or using them ineffectively. This in effect imposes a 'cost' of agency on shareholders. An efficient takeover market can reduce these costs by threatening the jobs of underperforming management.[92] This argument relies on the Efficient Capital Markets Hypothesis (ECMH) which postulates that the trading price of a stock will constantly adjust to reflect available information.[93] The semi-strong form of the hypothesis, which posits that market prices will respond only to publicly available information, has been supported by a number of studies even as other forms of the

[87] Hare, above n2, at 782.
[88] Mead, above n49.
[89] Zamri Ahmad, Haslindar Ibrahim and Jasman Tuyon "Institutional investor behavioural biases: syntheses of theory and evidence" (2017) 40 Management Research Review 578 at 586-587.
[90] Ahmad, Ibrahim and Tuyon, above n89.
[91] Hare, above n2, at 782.
[92] Davies, above n11, at 541.
[93] Hendrik S Houthakker and Peter J Williamson *The Economics of Financial Markets* (Oxford University Press, New York, 1996) at 137.

hypothesis have been criticised.[94] According to the ECMH, managerial incompetence and self-serving behaviour that is known about will be reflected in a company's share price.[95] Any publicly known internal governance rules which allow for self-serving behaviour will potentially have the same effect. When the difference between a company's 'true value', its value without the discount for agency costs, and its traded value is enough to justify the premium paid on a takeover that company becomes an attractive target for potential bidders.[96] The expectation is in order to achieve a profit, the acquirer will remove and replace the underperforming management.[97] As a result, an active market for corporate control can be said to threaten the jobs of ineffective management and thereby disincentivise incompetence and self-serving behaviour.[98] This in turn disciplines mangers and reduces agency costs. From this perspective, takeover defences should be prohibited because their only function is to entrench ineffective management.[99]

Critics have, however, raised considerable doubt about the extent to which takeover threats actually discipline management. The strongest case comes from Coffee who argues that even if hostile takeover threats may reduce self-dealing, that extent to which they can do so is limited.[100] According to Coffee, managerial self-dealing alone cannot account for severe enough declines in stock prices to justify the high premiums, on average around fifty percent of the share price, paid by bidders.[101] Managers' conduct would have to be so egregious as to have cost the company a large portion of its value to justify this premium.[102] The argument that takeover threats can reduce managerial incompetence is somewhat stronger if only because internal monitoring mechanisms can be expected to be alert to potential takeover threats. These mechanisms will in theory detect and address poor

[94] Houthakker and Williamson, above n93, at 138.
[95] Henry G Manne "Mergers and the Market for Corporate Control" (1965) 73 J Pol Econ 110.
[96] Coffee, above n10.
[97] Frank H Easterbrook and Daniel R Fischel *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, 1991), at 112-114.
[98] Easterbrook and Fischel, above n97.
[99] Bebchuk at 21.
[100] Coffee, above n10, at 1200.
[101] At 1200 – 1201.
[102] At 1201.

managerial performance before it becomes severe enough to create a realistic takeover threat.[103] This seems to suggest that while in theory takeovers should have a disciplining effect, in practice any such effect is limited. The key issue is that in order for takeover threats to reduce managerial misconduct, poor management needs to be the, or at least a, key driver of reduced share prices. The evidence suggests that is not the case.[104]

During an economic crisis, shares can be significantly undervalued or discounted independent of poor management. Much of the evidence suggests that market sentiment and volatility are more important drivers of the declines observed in share values.[105] In theory even a company with flawless management can have its profitability and stock price driven down by virtue of border restrictions, lockdowns, and overall reduced economic activity.[106] As a result even well managed companies may be left vulnerable to takeover threats. This suggests that takeovers, and by extension the ‘no frustration’ rule, do little to reduce agency costs during times of economic crisis. Furthermore, studies suggest that takeover threats may, in some cases, even reduce managerial effort.[107] This can occur when a company faces a constant threat of takeover which is not caused by managerial fault. As a result, the no frustration rule may actually exacerbate the problem of managerial ineffectiveness during times of economic crisis.[108]

A related issue which needs to be addressed is the argument that if takeover defences were allowed, they would inevitably be abused. Allowing defences, which are in effect a veto of takeover bids, risks giving managers too much power to self-deal.[109] By enabling management to practically decide which bids go to shareholders, takeover defences can be

[103] Coffee, above n10, at 1202.
[104] At 1201 - 1202.
[105] Mead, above n49; Noerr LLP, above n54.
[106] Stannard, Steven and McDonald, above n46, at 3 - 6.
[107] Marco A Haan and Yohanes Riyanto “The effects of takeover threats on shareholders and firm value” (2006) 59 Journal of Economic Behavior & Organization 45 at 61-62
[108] Haan and Riyanto, above n107, at 61-62.
[109] Lucian Arye Bebchuk *The Case Against Board Veto in Corporate Takeovers* (National Bureau of Economic Research, NBER Working Paper No. 9078, July 2002) at 20.

a potent tool for managers who want to negotiate favourable positions for themselves.[110] Bebchuk warns that managers may even reject offers which are objectively good for shareholders if those offers are not also in the managers' own interests.[111] This is possible in theory, but in practice the argument assumes that managers are unregulated and will pursue their own best interests at the expense of everyone else.[112] The argument is simply not tenable. While it would be naïve to pretend that managers are incapable of self-dealing, it is misleading to ignore the myriad of mechanisms in place to prevent precisely the level of self-dealing Bebchuk warns about.[113] These include the fact that directors are increasingly paid in stock which aligns their interests with those of shareholders and incentivises them to monitor managerial action.[114] Excessive self-dealing risks shareholders bringing derivative actions on behalf of the company if managers' decisions jeopardise the company's value.[115] Corporate governance rules, for example section 131 of the Companies Act which requires directors to use their powers in good faith and for the best interests of the company, may also act as a check.[116] Permitting managers to self-deal to the extent Bebchuk warns of would presumably violate that rule. Furthermore, defensive actions, in absence of a 'no frustration' rule, would likely remain subject to review by the Courts. Anything so blatant as frustrating an offer which benefits shareholders on the basis of self-interest will likely be found to be an illegitimate exercise of powers.[117] These mechanisms and others will likely prevent rampant self-dealing in the takeover context.

3 The Problem of Poor Performance

A series of studies into the factors which prompt takeover bids also casts on the value of takeover threats for promoting economic efficiency. These studies suggest that companies

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[110] Bebchuk, above n109, at 18.
[111] At 26-27.
[112] Stephen M Bainbridge "Director Primacy and Shareholder Disempowerment" (2006) 119 Harv. L. Rev. 1735.
[113] Bainbridge, above n112, at 1746-1747.
[114] At 1741.
[115] At 1741
[116] Companies Act, s 131.
[117] *FXHT Fund Managers Ltd (in Liq.) v Oberholster*, above n67; *Hogg v Cramphorn Ltd*, above n70; *Howard Smith Ltd v Ampol Petroleum Ltd*, above n69.

which are performing very poorly do not make for attractive takeover targets.[118] According to Franks and Mayer, albeit in a UK context, there was little evidence of poor performance prior to takeover offers being made.[119] This suggests that internal failures causing decline in share prices are not often an important driver of takeover bids. These studies undermine the argument in favour of the 'no frustration' rule that takeovers promote resource allocation efficiency and effective management.

Similar studies suggest that truly financially distressed firms, those with little or no prospect of recovery, appear to be relatively immune to takeover threats.[120] For some investors, it seems often the most attractive targets are those which are efficiently run but for one reason or another have a share price which is not reflective of its true value.[121] This seems to suggest then that the conditions for an attractive takeover target are significant discount on the market price of shares relative to true value and a prospect of future recovery or gain. Both of these elements can be seen in the COVID 19 economic crisis where companies' share prices have been driven below what they might be in a pre-crisis market by factors which could not have been predicted or realistically prepared for. Even strongly performing companies are not immune to the external factors, such as lockdowns and border restrictions, at work. More importantly many of these factors such as the aforementioned lockdowns are temporary in nature. If anything, those stronger performing companies may therefore present more attractive targets for their prospects of post-crisis recovery.

B Value Generation

Even when companies use resources efficiently and have minimal agency costs, proponents of the 'no frustration' rule argue that takeovers can generate value for companies and their shareholders. Although not expressly cited as a rationale for New Zealand's 'no frustration'

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[118] Davies, above n11, at 541.

[119] Julian Franks and Colin Mayer "Hostile takeovers and the correction of managerial failure" (1996) 40 J. Fin. Econ. 163 at 175-176.

[120] Coffee, above n10, at 1203 - 1204.

[121] Lee B Thomas "Hostile Takeovers: When the Vultures Call" (1992) 82 Business and Society Review 60 at 60-61.

rule it is nonetheless a common argument against allowing the use of takeover defences.[122] Evidence of post-takeover value increases for either or both of the target and acquirer companies supports this claim. One study of the banking sector showed that the value of the target company's shares increased without significant corresponding decrease in the value of the bidder's shares.[123] This suggests some overall gain in value resulting from the takeover.[124] These findings are consistent with those of Guest, Bild, and Runsten who examined both the profitability and fundamental value of companies post-takeover.[125] Their study found that both companies' profitability increased significantly after a takeover.[126] Although the fundamental value of the acquirer was unchanged, this was attributed to the costs involved in the takeover itself.[127] A related study found that the returns to shareholders of companies which had successfully resisted a takeover were significantly lower than the returns to shareholders of companies which had been acquired.[128] This suggests shareholders in target companies derive profits from a successful takeover and supports the argument that takeovers can generate value for shareholders. However, there are also several studies which found no increased profitability.[129] Overall the evidence seems to suggest that takeovers can be valuable, particularly for target companies and their shareholders, but not in all cases.

The value generation arguments often cite improvements to productive efficiency as the cause of post-takeover value increases.[130] Corporate synergy between the companies involved in a takeover can increase profitability where the acquirer and bidder have compatible businesses.[131] Post takeover mergers may also enable companies to better

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[122] Simonson, above n64.
[123] Simonson, above n64.
[124] Simonson, above n64.
[125] Paul M Guest, Magnus Bild and Mikael Runsten "The effect of takeovers on the fundamental value of acquirers" (2010) 40 A & B R 333 at 334.
[126] Guest Bild Runsten, above n125, at 350.
[127] At 334
[128] Bebchuk, above n109, at 19-20
[129] Dugan, above n83, at 53-54.
[130] Chatterjee, above n3, at 269-270.
[131] At 269.

exploit economies of scale and reduce the costs of production or service provision.[132] Both of these can generate value for the companies involved and their shareholders by reducing costs or otherwise increasing profits. At the same time, these improvements to productive efficiency can potentially improve overall efficiency in the economy.

However, although there is considerable evidence of post-takeover value increases for companies and their shareholders, there remains some debate about whether takeovers are actually 'value-creating'. This is because while there is evidence of value derived from takeovers, the source of that value is considerably less clear. Davies suggests that post-takeover gains may not be derived from improving the productive efficiency of the company but rather from imposing costs on stakeholder groups or transferring wealth between shareholders.[133] The New Zealand Securities Commission also raised this issue of wealth shifting, describing it as 'financial legerdemain', when they considered whether to recommend a 'no frustration' rule.[134] Costs to stakeholders may include reneging on informal arrangements made between outgoing management and employees[135] or losses to creditors when control shifts lower the credit rating of either target or acquirer[136]. Wealth transfers between the acquirer and target shareholders can occur where an excessive premium is paid for the target's shares.[137] Tax avoidance strategies implemented as part of post-takeover restructuring may transfer wealth from taxpayers.[138] In a review of literature, five out of seven scenarios identified to explain shareholder gains in a takeover involved wealth transfer rather than improvements to productive efficiency.[139] Where the source of value is costs imposed on external parties, and there is considerable evidence suggesting that this is the case, rather improvements to productive efficiency takeovers arguably do not create value. The concern is that takeovers' value generating effects may be overstated if all they do is transfer wealth from external parties to shareholders.

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[132] Chatterjee, above n3, at 269.
[133] Davies, above n11, at 543.
[134] Securities Commission, above 60, at 193.
[135] Davies, above n11, at 548.
[136] At 545.
[137] At 550.
[138] Securities Commission, above n60, at 193.
[139] Dugan, above n83, at 54-56.

C Shareholder Sovereignty

New Zealand's history of takeover regulations demonstrates a strong emphasis on the principle of shareholder sovereignty.[140] According to this principle shareholders should be the ones to decide whether to sell their shares.[141] Framed another way, the decision whether or not to accept an offer is not a 'management decision' and is therefore not one for management to make. Traditionally shareholder sovereignty is a recognition that shareholders, as residual owners, should have the right to do with their shares in a company as they see fit.[142] As a hostile takeover is fundamentally an offer to purchase the shareholders property it should be their absolute right to sell it. That being said directors are still permitted to influence the decision making process.[143] New Zealand's Takeovers Code for instance permits directors to advise shareholders against accepting a bid or even seek competing offers from white knights.[144] Rule 19 of the Code requires directors to make recommendations to shareholders on whether to accept a bid.[145] In all cases what is key is that shareholders are left with the ultimate choice. Directors may influence their decisions, but they cannot, through the use of defensive measures, deprive shareholders of the final right to decide how and when to dispose of their shares.[146]

Although important, shareholder sovereignty has been criticised for two reasons. The first of these relates to the nature of shareholders themselves. More specifically shareholders often lack the information and expertise which is necessary for making informed investment decisions.[147] Even when those informational asymmetries are remedied,

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[140] *FXHT Fund Managers Ltd (in Liq.) v Oberholster*, above n67; Companies Act, s 133; Takeovers Regulations, r 39.

[141] Gerner-Beuerle, Kershaw and Solinas, above n4, at 3.

[142] Chrispas Nyombi "A critique of shareholder primacy under UK takeover law and the continued imposition of the Board Neutrality Rule" (2015) 57(4) IJLMA 235 at 248.

[143] Paul Davies, Klaus Hopt and Wolf-Georg Ringe "Control Transactions" in Reinier Kraakman, (ed) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd ed, Oxford University Press, Oxford, 2017) 205 at 213.

[144] Takeovers Regulations, r 38.

[145] Rule 19.

[146] Bebchuk, above n109, at 30.

[147] William W Bratton and Michael L Wachter "The Case Against Shareholder Empowerment" (2010) 158 U Pa L Rev 653 at 689.

studies suggest that shareholders, both retail and institutional, are subject to a variety of cognitive biases which may drive them to make decisions in a non-rational way.[148] Secondly, the single minded focus on shareholder sovereignty can be criticised for vesting an enormous amount of power in shareholders' hands. The traditional view neglects that fact shareholders' decision whether to accept a takeover bid can have wide ranging effects on interests beyond their own.[149] Shareholders are not normally seen as having duties to the company, to stakeholders, to other shareholders, or to anyone but themselves. As a result, shareholder sovereignty also risks harm to stakeholders' interests. This is not to say shareholder interests should be subordinate to those of stakeholders, but rather the potential harm to stakeholders weights against the sovereignty principle.

1 Shareholder Protection

From the law and economics perspective the separation between shareholding and management is based on the idea of specialisation.[150] Under this view centralised and specialised management coordinate the nexus of contracts which form the corporation for the benefit of shareholders and, increasingly in modern conceptions, stakeholders.[151] Managers are given a set of powers necessary to manage the corporation because relative to management shareholders are much more likely to struggle with informational asymmetries and lack of expertise.[152] More recent studies also show a variety of behavioural biases in investors, such as the loss aversion bias, which affect the ways they invest.[153] As a result, sovereignty may actively harm shareholder interests. Klohn pithily describes the sovereignty-protection conflict as being between an investor's 'right to make a fool of [them]self'[154] and the need to protect investors from their own irrational decision

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[148] Ahmad, Ibrahim and Tuyon, above n89, at 595; Sujata Kapoor and Jaya M Prosad "Behavioural Finance: A Review" (2017) 122 Procedia Computer Science 50.

[149] Nyombi, above n142; Mark G Robilotti "Codetermination, Stakeholder Rights, and Hostile Takeovers: A Reevaluation of the Evidence from Abroad" (1997) 38 Harv Intl L J 536.

[150] John H Farrar "Frankenstein, Incorporated, or Fools Parliament? Revisiting the Concept of the Corporation in Corporate Governance" (2002) 60 Advocate (Vancouver) 23 at 30-33.

[151] Bainbridge, above n112, at 1749.

[152] Bratton and Wachter, above n147, at 688-716.

[153] Khaneman and Tversky, above n56.

[154] Klöhn, above n13, Klöhn attributes this quote to Professor Louis Loss.

making.[155] Economic crises can exacerbate the problems of information asymmetry. Even with perfect information shareholder irrationality can be exploited by opportunistic bidders and in times of crisis the risks of that exploitation increase significantly. As such there is a strong argument in favour of shareholder protection.

The core problem is that shareholders often lack the information that managers and directors have access to.[156] Although company law contains disclosure requirements and reporting obligations such disclosures can be difficult to understand for those without relevant training or expertise.[157] Even when information is made available, studies suggest that investors will often ignore information which is overly complex or comes in overly large amounts.[158] Furthermore, disclosing information can be costly for companies. These costs can include information distribution costs, increased litigation costs, and proprietary costs of giving competitors access to private information.[159] It is therefore inevitable that shareholders will not have access to all the information available to management; especially internal information relevant to the future of the company and sensitive information which are unlikely to be publicly available. Finally, the usefulness of information tends to change over time as it becomes outdated. As a result of this managers are usually better positioned to know the true value of a company at any given time than shareholders.

Part of this informational asymmetry can be attributed to rational apathy on the part of shareholders.[160] Gathering all the information required to accurately gauge the value of a company takes a great deal of time and money.[161] For most shareholders the gains derived from having this information are not worth the cost of obtaining it. Much of the information

[155] Klöhn, above n13, at 439

[156] Davies, Hopt and Ringe, above n143, at 224-225.

[157] At 225-226.

[158] Gerald Spindler "Behavioural Finance and Investor Protection Regulations" (2011) 34 J Consum Policy 315 at 322.

[159] Bratton and Wachter, above n147, at 697.

[160] David Kershaw *Company Law in Context: Text and Materials* (2nd ed, Oxford University Press, Oxford, 2012).

[161] Bainbridge, above n112, at 1745.

also requires a considerable amount of expertise to actually understand. As a result, even when that information is made available, interpreting it may be impossible or at least prohibitively costly.[162] The opportunity costs of remedying information asymmetries simply outweigh the benefits. This is especially true where shareholdings are small.[163]

The ECMH goes some way towards remedying these asymmetries, but not far enough. According to the semi-strong form of the ECMH a company's share price should reflect and incorporate any information available to the market, however, the information reflected will be public information only.[164] This information may not accurately reflect the long term viability of a company. Writing in the context of the effects of markets for corporate control on corporate innovation, Chemmanur observes that stock prices often only reflect the short term prospects of a company.[165] Thomas' observations that often low stock prices can reflect a focus on long term objectives over short term gains support that finding.[166] This suggests that even if the ECMH is enough to offset rational apathy, the information relied on by shareholders will not necessarily reflect any more than the short term prospects of a company. More long term initiatives and research and development will likely fall under the umbrella of sensitive information which likely only management will have access to.[167] As a result, management is usually also better positioned to assess the long term viability of a company.[168]

The informational asymmetry problem is unsurprisingly exacerbated by the COVID 19 economic crisis. Between public health measures which have stifled business activity and the general lack of knowledge of when this crisis will end, there is a great deal of uncertainty in financial markets.[169] Importantly many of the relevant external factors such

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[162] Spindler, above n158, at 322-323.

[163] Bainbridge, above n112, at 1745.

[164] Bratton and Wachter, above n147, at 691.

[165] 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 1164.

[166] Thomas, above n121, at 61.

[167] Bratton and Wachter above n147, at 697.

[168] Nyombi, above n142, at 236.

[169] Mead, above n49.

as lockdown restrictions and resurgences in COVID 19 are hard to predict and harder to prepare for. In the face of this uncertainty, assessing a company's short term prospects would be difficult even knowing all the available information. Managers, who have more information, are better positioned to make both short and long term assessments of a company's viability and value.[170] Therefore, it is arguably in the best interests of shareholders to enable a certain degree of managerial intervention in filtering out and preventing excessively low takeover bids.

One suggestion for addressing informational asymmetry is to treat the Board as having an advisory role.[171] This approach is reflected in New Zealand's current takeover regulations which task boards with advising shareholders on whether to accept a bid and seeking or promoting alternatives.[172] Providing this advice is mandatory.[173] While it is easy to see the appeal in such an approach, namely it informs shareholders without removing their right to choose, information asymmetry is only one of many factors which supports the use of takeover defences as a response to economic crises. Having access to information arguably does little where shareholders do not act on it in a rational way.[174]

Even with perfect information, irrational decision making can still harm shareholder interests. Under the traditional 'rational investor' paradigm, shareholders will collect all available information, assess that information, and then make a rational decision in pursuit of their own interests.[175] However in recent years there has been an increased recognition that investors, both retail and institutional, do not always act in a rational way.[176] According to behavioural finance, investors are subject to a number of psychological and cognitive biases which mean investment decisions are not made on a purely utilitarian basis.[177] This means that shareholders are not always rational and cannot in all cases act in

[170] Nyombi, above n142, at 236.
[171] Bebchuk, above n109, at 28.
[172] Davies, Hopt and Ringe, above n143, at 213.
[173] Takeovers Regulations, r 19.
[174] Kapoor and Prosad, above n148, at 51.
[175] Spindler, above n158, at 317.
[176] Kapoor and Prosad, above n148, at 51.
[177] At 52.

pursuit of their own best interests. Behavioural theorists further argue that decisions can be influenced by anything from state of mind to emotions to beliefs to trading theories.[178] Two key behavioural finance theories have emerged, heuristic theory[179] and prospect theory[180].

Heuristic theory posits that when a decision is complex decision makers will rely on a series of decision making shortcuts. These work well under most circumstances but do not reflect the traditional rational investor model of decision making.[181] Of particular relevance here are the anchoring, representativeness, and herding heuristics. According to the anchoring heuristic, investors are likely to base assessments of future movements of share prices on recent movements in the stock market.[182] Similarly, the representativeness heuristic refers to investors' tendency to view recent changes as representative of future ones.[183] Herding refers to the tendency to act in the same way as a large group.[184] Taken together these heuristics suggest that during an economic crisis, recent declines in price may be seen a predictor of future declines. Furthermore, if a large number of shareholders are selling off their holdings, others may do the same for no other reason than that the group is doing so.

Prospect theory meanwhile describes a set of behavioural biases which may influence investment decisions.[185] The most important in the context of crisis motivated hostile takeovers is the loss aversion bias.[186] According to Kahneman and Tversky people tend to treat losses as more heavily weighted than an equivalent gain.[187] It follows then that investors are more motivated to avoid losses than they are to actively pursue gains. Those

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[178] Mydhili Virigineni and M Bhaskara Rao "Contemporary Developments in Behavioural Finance" (2017) 7 International Journal of Economics and Financial Issues 448 at 449.

[179] At 452.

[180] Kahneman and Tversky, above n56.

[181] Virigineni and Rao, above 178, at 452.

[182] At 454, see Table 6.

[183] At 454.

[184] At 455, see Table 7.

[185] Kahneman and Tversky, above n56.

[186] Virigineni and Rao, above n178, at 451, see Table 1.

[187] Kahneman and Tversky, above n56, at 263.

same people also tend to assess the utility of a decision relative to their status quo, their current position.[188] This may motivate them to hold onto losing positions and sell off winning positions relative to their current ones. Put in other words, a shareholder's loss averseness may be exploited by opportunistic bidders in times of economic crisis by offering an opportunity to cash out at more than what their current position is worth and avoid a potential loss.

The combination of heuristics and biases can potentially influence shareholders to act in ways contrary to their own interests. The anchoring and representativeness heuristics may encourage shareholders to treat recent trends as predictive of future ones.[189] With the early effects of COVID 19 this may drive shareholders to anticipate future declines in the values of their shares. In light of this, loss averseness may motivate shareholders to accept takeover bids even when they are undervalued relative to what the same takeover might be worth in a pre-crisis market. Taking the status quo position as the depressed crisis value of the relevant shares, shareholders may be motivated to accept offers even slightly above the status quo even where that offer is considerably below what they might be offered in a pre-crisis market.[190] The alternative in this hypothetical would be the risk of even further losses resulting from the aforementioned anticipated declines. The goal in this case is not to maximise utility, as the classical rational shareholder might, but rather to avoid loss. In essence, prospect theory suggests that shareholders may accept bids for fear of losing the premium offered.[191] Finally, if a large number of shareholders opt to sell, the herding heuristic suggests more will follow even without traditionally rational reasons to do so.

2 Stakeholder Interests

The idea that shareholder interests should be balanced against a wider set of concerns is not a new one in the broader context of corporate governance. Many have recognised a need to balance shareholder primacy against the company's best interests and the interests

[188] Kahneman and Tversky, above n56, at 286-288.

[189] Virigineni and Rao at 454-455

[190] Kahneman and Tversky, above n56, at 268 and 286.

[191] Ronald J Gilson and Reinier Kraakman "The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias" (2003) 28 J Corp L 715 at 732.

of stakeholders.[192] Stakeholder theory, in the context of directors' duties, argues that in performing their corporate governance functions, managers should act for the benefit of the company as a whole. This includes protecting shareholders' interests but also being responsive to the needs of other stakeholders including employees, creditors, the environment and even broader social responsibility.[193] The recognition of stakeholder interests is in some ways a recognition of the fact that a corporation should not merely enjoy the legal rights of personhood without also being subject to corresponding social obligations.[194] Although usually discussed in the context of directors duties, this consideration is arguably just as important in relation to takeovers which can have massive impacts on stakeholder interests.[195] The difference is that in the takeover context stakeholderism goes further than it does in the context of directors duties and is used as an argument for curtailing the rights of shareholders. This is not to say that shareholders should subordinate their interests to those of stakeholders. Rather it is a recognition a that in many instances shareholders actions can have wide ranging effects which 'no frustration' rules effectively neglect.

During a hostile takeover, the rights and interests of a variety of groups, not just shareholders, will be affected. Employee and creditor interests are particularly salient in the present case. Employees may suffer if jobs are cut as a part of a post-takeover restructure.[196] For instance in the leveraged buyout (LBO) of Safeway shareholders reaped massive benefits but in order to pay down the moneys borrowed against Safeway's assets to finance that LBO Safeway was forced to eliminate over 9,000 jobs.[197] Losses to creditors can arise when control shifts lower the credit rating of the target or affect that target's

[192] See for example: Lynn Stout "The Toxic Side Effects of Shareholder Primacy" (2013) 161 U. Pa. L. Rev. 2003; Rob Everett "Thinking beyond shareholders" (Presentation by Rob Everett at the NZ Capital Markets Forum, New Zealand, March 2019); Larry Fink "A Fundamental Reshaping of Finance" (2020) Blackrock <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>.

[193] Silvia Ayuso, Miguel A Rodríguez, Roberto García-Castro and Miguel A Ariño "Maximizing Stakeholders' Interests: An Empirical Analysis of the Stakeholder Approach to Corporate Governance" (2014) 53 Business & Society 414 at 417.

[194] Farrar, above n150, at 36-37.

[195] Nyombi, above n142, at 236.

[196] Robilotti, above n149, at 538.

[197] At footnote 60.

ability to repay debts.[198] Even environmental, sustainability, and corporate social responsibility interests can be impacted if an acquirer's policies and practices do not adequately account for those interests.[199] The growing importance of stakeholderism in corporate governance means that attentiveness to stakeholder interests will likely factor into the welfare of the company as a whole.[200] Put another way, a shareholder's decision to sell their shares is a decision which affects a wide variety of interests beyond their own.

Critics of the stakeholder interest argument for takeover defences point to the risk of management using stakeholder interests to justify actions which confer no benefits to stakeholders.[201] Allowing management to utilise takeover defences on the basis of stakeholder protection is seen as little more than giving management a broad discretion to self-deal.[202] Some warn that the use of certain defences can even be directly harmful to stakeholder interests.[203] These defences include greenmail which involves paying bidders to withdraw their bid, golden parachutes which are massive sums paid out to management leaving the company in the wake of a takeover, and LBOs which involve borrowing against the company's assets to make a competing bid for shares. Each can massively increase a company's debt or reduce its assets. In most cases the costs are left to be borne by stakeholders. The problem with this study is that it tends to focus on defences which tend to over leverage a company, such as an LBO, or those where management is effectively just transferring funds to themselves, as in a golden parachute, which will inevitably be costly to the company. While this study suggests some defences are harmful to stakeholders it does not go so far to suggest all defences can be harmful.[204] Defences like these are unlikely to be beneficial to stakeholders, however, evidence that some defences may harm stakeholders is no ground to infer that all defences will harm stakeholders, especially where

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[198] Davies, above n11, at 545.

[199] Aleksandra Kacperczyk "With Greater Power Cones Greater Responsibility? Takeover Protections and Corporate Attention to Stakeholders" (2009) 30 Strat Mgmt J 261 at 261.

[200] Fink, above n192.

[201] Bebchuk, above n109, at 49.

[202] At 53.

[203] Ken Hanly "Hostile Takeovers and Methods of Defence: A Stakeholder Analysis" (1992) 11 Journal of Business Ethics 895 at 907.

[204] Hanly, above n203.

that harm appears to be derived from the methods employed by the defence and not the fact of the defence itself.

Shareholders are arguably not in the best position to balance their own interests against the interests of others. This is especially true during an economic crisis where shareholders are likely to, very understandably, be more motivated by a need to protect their investments or escape a declining market. This and the growing recognition that stakeholder interests are important from the corporate governance standpoint suggests there needs to be more of a balance between the sovereignty principle and protecting non-shareholder interests. The argument is not that shareholders should subordinate their interests to stakeholders, but rather that in certain circumstances the negative externalities may from a policy perspective weigh heavily against the sovereignty principle. Management will likely be the best placed to ensure stakeholder interests are not left to the wayside in the event of a takeover. In such cases managers should have the option to make use of defences which would enable them to negotiate terms which also protect the interests of stakeholders. This is another factor weighing against the shareholder sovereignty principle.

IV The Value of Defensive Tactics

A Bargaining Power

In the event of a takeover bid, takeover defences give management a stronger position to negotiate vis a vis the bidder. When this bargaining power is exercised in favour of shareholders, it can increase the value of that takeover for said shareholders.[205] Defensive tactics essentially turn management into a gatekeeper, giving them the ability to negotiate on behalf of shareholders.[206] In theory this can discourage low bids or enable management to extract more value from bidders. With the economic downturns caused by COVID 19, market prices are unlikely to be reflective of a company's actual value. As a consequence, the risk of bidders making low offers and shareholders missing out in a hostile takeover is increased considerably. As discussed earlier, management will likely be in a better position

[205] Davies, Hopt and Ringe, above n143, at 218.
[206] At 218.

to know the actual value of a company, without its crisis discount. Therefore, takeover defences, through giving management bargaining power, can help to protect shareholders from being taken advantage of.

A number of studies support the argument that takeover defences allow management to negotiate higher premiums for shareholders.[207] The contentious issue is whether managers actually exercise this power in favour of shareholders. Some studies have found evidence of a positive effect of existing takeover defences on takeover premia.[208] According to Pearce and Robinson having a poison pill in place tends to increase shareholder wealth.[209] However, some studies have found no effect or alternatively that takeover defences reduce shareholder value.[210] Some go further to point out that while takeover defences do give managers increased bargaining power, there is every chance management will use that power to negotiate terms favourable to themselves.[211] Although that view has been criticised as assuming management are free to run rampant in pursuing their own interests, it cannot be ignored that takeover defences do enable management to effectively dictate terms to prospective acquirers.[212] There is also some concern surrounding the fact that, in the American context where many of these studies were conducted, defences like the poison pill can easily be implemented pre or post bid.[213] In effect even companies without pills may be able to rapidly implement or threaten to implement them as a response to bids. This may distort results by making it impossible to assess whether differences in the takeover premia obtained are actually associated with the presence of takeover defences.[214] Overall while the evidence is not entirely conclusive it provides some initial support for the idea that takeover defences give management increased bargaining power and may result in higher takeover premia for shareholders.

[207] Nyombi, above n142, at 251.
[208] Bebchuk, above n109, at 37.
[209] John A Pearce and Richard B Robinson "Hostile takeover defenses that maximise shareholder wealth" (2004) 47 Business Horizons 15 at 23.
[210] Nyombi, above n142, at 251.
[211] Bebchuk, above n109, at 37.
[212] Bainbridge, above n112, at 1745.
[213] Nyombi, above n142, at 251.
[214] At 251; Bebchuk, above n109, at 37.

B Protecting Stakeholders

Granting management increased bargaining power in the takeover context can, additionally, be of benefit to stakeholders. It is clear that stakeholders' interests can be hugely impacted by a hostile takeover.[215] In theory, if defences were to be permitted in New Zealand and become a legitimate exercise of managerial or directorial power, the exercise of that power would likely fall to be governed by the Companies Act and the directors' duties contained within.[216] This includes, importantly, the duty to act in good faith and in the best interests of the company.[217] A variety of sources suggest that in the long term it is in a company's best interests to pay attention to stakeholders and their interests.[218] As such it is not so farfetched to say that if defensive tactics were permitted and directors were put in a position of having to negotiate, directors may be bound by a duty to ensure both shareholder and stakeholder interests are looked after in the context of takeovers.

The mere fact of having defences in place has also been suggested to be beneficial to stakeholders. A study in 2009 found that managers tended to pay increased attention to long term and stakeholder interests when takeover defences were in place.[219] Specifically, when freed from constant threat of a takeover, managers tended to take a broader view of what was in a company's interests and paid more attention to employee, customer, and even environmental sustainability interests.[220] By contrast, in absence of takeover defences managers tend to prefer the short term interests of shareholders to the exclusion of all else out of a fear of losing their jobs.[221] With the growing recognition of the interests of stakeholders in corporate governance as a whole, it could be argued that takeover defences have value even outside the takeover context for enabling management to better look after

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[215] Davies, above n11, at 544-548; Robilotti, above n149 at 538.

[216] Companies Act, ss 131-138B.

[217] Section 131.

[218] Kacperczyk, above n199, at 280.

[219] At 280.

[220] At 278.

[221] At 276.

the interests of stakeholders. While in the short term this focus may impose costs on the company, in the long term paying more attention to stakeholders has also been suggested to result in higher returns for shareholders.[222]

C Value for Shareholders

Independent of increasing bargaining power and benefits to stakeholders, takeover defences can also increase company performance and shareholder value.[223] These benefits arise predominantly from the ability to focus more on long term initiatives without having to worry about opportunistic threats in the short term. As has been noted before a company's stock price often only reflects its short term prospects.[224] This is likely because, in accordance with the ECMH, the stock price will only reflect public information and longer term research and development or business initiatives will more often than not be sensitive information companies are unlikely to want in the hands of competitors.[225] Chemmanur's research on defences and innovation provides broad support for this argument.[226] When a company is regularly engaged in long term projects, the implementation of takeover defences can improve that company's value due to the perception of the defence as a tool for short term protection.[227] If a company does not engage in long term projects defences are perceived as a tool for managerial entrenchment and may reduce shareholder value.[228] This strongly suggests defences can generate value for shareholders in the longer term provided managers take on longer term projects.

V Alternatives to Takeover Defences

Notwithstanding the value that takeover defences can provide for both shareholders and stakeholders, there remain strong policy arguments in favour of restricting the use of takeover defences. Even during COVID 19, where the value of takeovers is called into

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[222] Kacperczyk, above n199, at 279-280.
[223] Chemmanur and Tian, above n165, at 1911.
[224] At 1164; Thomas, above n121, at 61.
[225] Houthakker and Williamson, above n93, at 138.
[226] Chemmanur and Tian, above n165.
[227] At 1189.
[228] At 1189.

question and the risk of shareholders informational asymmetries and irrational decision making being exploited is greatly increased, there is still evidence that takeovers generate value. The importance of shareholder sovereignty also cannot be overlooked. Therefore, it is important to consider whether alternative responses are sufficient to address this crisis without taking what would in New Zealand be a controversial step of allowing the use of defences. Here it is instructive to consider how other, similar, countries have responded to the COVID crisis.

A UK and Australia

1 The UK

The UK takes a restrictive approach to takeover defences with a board neutrality rule which effectively prohibits the use of takeover defences.[229] Like New Zealand the UK relies on a 'Takeover Code' (the UK Code) to govern corporate takeovers.[230] This code is administered by a Takeovers Panel (the UK Panel).[231] The UK Panel is in turn empowered and governed by the UK Companies Act 2006.[232] Under the UK Code's rule 21 the board of a target company is prohibited from taking any action which may frustrate an offer or potential offer unless they have the approval of shareholders.[233] If there is any doubt about whether an action may constitute a breach of Rule 21 the target company's board must consult the UK Panel. Under UK law the use of takeover defences aimed at frustrating an offer are effectively prohibited.

In the absence of takeover defences, UK companies have had to rely on legislative action to address the increased risk of hostile takeovers arising from COVID 19.[234] Amendments to the Enterprise Act passed in June (the June Order) gave the UK government greater

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[229] Gerner-Beuerle, Kershaw and Solinas, above n4; City Code on Takeovers and Mergers 1968 (UK), r 21.
[230] City Code on Takeovers and Mergers (UK).
[231] Alastair Hudson *Understanding Company Law* (2nd ed, Routledge, New York, 2017) at 230.
[232] Companies Act 2006 (UK).
[233] City Code on Takeovers and Mergers (UK), r 21.
[234] Department for Business, Energy & Industrial Strategy and Sharma, above n57.

powers to scrutinise takeovers of businesses necessary to combat public health crises.[235] Prior to the amendment, UK law allowed the Secretary of State to intervene in situations where a merger may have public interest implications.[236] The Secretary of State, on making a finding of public interest concerns, may intervene and in certain cases even stop a takeover.[237] 'Public interest' is defined as including national security interests, media plurality interests, and protecting the stability of the UK financial system.[238] The June Order added as a specified public interest consideration "the need to maintain in the United Kingdom the capability to combat, and to mitigate the effects of, public emergencies specified in this section".[239] The risk of nationally important, financially distressed, companies being sold to 'malicious parties' is noted as a key concern driving this reform.[240] This amendment is understood to allow the government to intervene when liquidity issues caused by COVID 19 risk businesses such as vaccine producers, PPE manufacturers, or those essential to the food supply chain being subject to a foreign takeover.[241] A similar amendment is aimed at expanding scrutiny to sensitive areas of the economy including AI, cryptographic authentication technology, and advanced materials.[242] On the wording of these statutes, the scope of the 'protection' appears incredibly limited. It seems any business which does not fall under the categories covered by the original Act or amendments is left without any meaningful way to protect themselves from opportunistic takeover bids.

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[235] The Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2020 (UK) ("The UK Enterprise Act Order").

[236] Enterprise Act 2002 (UK), s42.

[237] Section 55, Schedules 7 and 8.

[238] Section 58.

[239] The UK Enterprise Act Order, art 2.

[240] Company Lawyer "COVID-19 helps prompt significant reforms to UK foreign takeover control regime" (2020) 41 Comp Law 266.

[241] Marc Israel and Kate Kelliher "UK ushers in new foreign takeover restrictions for Coronavirus-critical businesses and national security activities" (22 June 2020) White & Case <https://www.whitecase.com/publications/alert/uk-ushers-new-foreign-takeover-restrictions-coronavirus-critical-businesses-and>.

[242] Company Lawyer, above n240.

2 Australia

Australia's takeover regulations have similar components to those of the UK and New Zealand. Their Takeover Code (the Australian Code) contains the procedural rules for carrying out a takeovers[243] and their Takeover Panel enforces compliance with that code.[244] Like the UK, Australian takeover regulations prohibit actions which may frustrate a takeover offer. Australia's regulation of defences is contained predominantly in their Takeover Code of 1968.[245] Under General Principle 4, the targets board is prohibited from taking any action which may frustrate a current offer or an offer they know to be coming.[246] This significantly reformed the law of Australia prior to the Australian Code which involved considerations of the board's purpose and whether those purposes were proper.[247]

The Australian government was quick to respond to the economic downturn caused by COVDI 19. In March they announced changes to their foreign investment rules, removing the monetary value threshold for scrutinising such investments.[248] This change effectively expands the scope of the 'national interest' test and the Treasurer's power to scrutinise and refuse approval for takeover bids from foreign governments and investors.[249] Prior to these reforms the Foreign Acquisitions and Takeovers Regulations only allowed the Treasurer to scrutinise takeover proposals from 'foreign persons' that met a certain value threshold.[250] 'Foreign person' is defined as including natural persons, and corporations and trust estates controlled by, or with substantial interests belonging to, people not ordinarily resident in Australia.[251] For non-sensitive businesses, the threshold was considerably

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[243] Emma Armson "Lessons for the Australian Takeovers Panel from the United Kingdom" 2014 ACLJ 6 at 15; Corporations Act 2001 (Cth).
[244] Armson, above n243, at 19-20; Corporations Act (Cth).
[245] Corporations Act (Cth).
[246] Armson, above n243, at 21.
[247] Armson, above n243, at 23; *Howard Smith Ltd v Ampol Petroleum Ltd*, above n69.
[248] French, Irwin and Ralston, above n57; Foreign Acquisitions and Takeovers Amendment (Threshold Test) Regulations 2020 (Cth).
[249] Foreign Acquisitions and Takeovers Regulation 2015 (Cth).
[250] Thomas Chiu, David Flint, Belinda Robilliard and Philippa Stone (eds) *The Laws of Australia* (online loose-leaf ed, Thomson Reuters) at [24.2.330] and [24.2.1470].
[251] At [24.2.430].

higher and only applied to foreign regional or government investors.[252] For sensitive businesses in areas of media, telecommunications, transport, military manufacturing, defence production, security technologies, communications systems, or nuclear facility related activity the threshold was considerably lower and the Act covered all foreign investors.[253] In determining what is "contrary to the national interest" the Treasurer has a broad discretion.[254] What factors are and are not relevant to whether a takeover is against the national interest is "conceptually broad" and can change over time.[255] Should the treasurer determine a transaction is against the national interest they have broad powers to impose conditions on it or even to prohibit it.[256] The original regulations essentially imposed extra scrutiny for takeovers which may affect Australia's national interest, and exclusively focussed on takeovers proposals by foreign acquirers. The 2020 reforms effectively grant the government a greater mandate to scrutinise those same transactions. In theory this should provide more protection where foreign investors and or sensitive businesses are involved. For any non-sensitive businesses or businesses subject to domestic takeover bids this Act provides little recourse.

B New Zealand's Response

New Zealand's own response is based in legislative reform. With takeover defences effectively prohibited by the Code, companies have been forced to rely on the government for additional takeover protections. Parliament recently passed the Overseas Investment (Urgent Measures) Amendment Bill under urgency with the aim of enhancing the government's ability to respond to foreign investments.[257] Under this amendment any "transaction of national interest" cannot proceed where the Minister responsible for administering the act (the Minister) declines consent on grounds of the transaction being contrary to New Zealand's national interest.[258] "National interest transactions" include any

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[252] Foreign Acquisitions and Takeovers Regulation (Cth), s 59.
[253] Sections 22 and 59.
[254] Chiu, Flint, Robilliard and Stone, above n250, at [24.2.1170].
[255] At [24.2.1180].
[256] At [24.2.1370].
[257] (27 May 2020) 745 NZPD (Overseas Investment (Urgent Measures) Amendment Bill — Second Reading, Aupito William Sio).
[258] Overseas Investment Act 2005, s20C.

transactions which would result in a non-New Zealand government owning a certain value in New Zealand property or more than a certain interest in businesses.[259] It also includes similar investments in certain strategically important businesses by non-government foreign investors.[260] Essentially this reform has introduced a new ground on which the Minister can decline consent to an overseas investment transaction. It also introduces a 'national interest' test into New Zealand's law of overseas investments.[261]

New Zealand's reforms, according to HANSARD debates and the legislation itself, are intended to enhance scrutiny of takeovers proposed by certain foreign investors and of businesses important to national interests.[262] With the increased risk of hostile takeovers caused by the ongoing COVID 19 economic crisis it is somewhat concerning that the government's interventions ostensibly do nothing to address domestic takeover threats. Furthermore the law seems to leave non-strategically important businesses open to foreign hostile takeovers. Although it should be noted those takeovers would be subject to other rules of the Overseas Investment Act.[263] Although New Zealand's approach differs technically from the UK and Australian approaches in the amendments made to the relevant legislation, functionally the three achieve the same result. Responses in the UK, Australia, and New Zealand appear not to be aimed at providing companies with protection from opportunistic investors so much as from foreign ones. Any protections from opportunistic takeovers are in reality a side effect of what appears to be legislation designed to protect national interests. The result is somewhat disappointing in that it seemingly does little to address corporate vulnerability caused by the virus for corporations affected by COVID 19 that are not vital to a country's national interest or are subject to domestic takeover pressures.

[259] Overseas Investment Act, s 20A.
[260] Section 20A.
[261] (27 May 2020) 745 NZPD (Overseas Investment (Urgent Measures) Amendment Bill — Second Reading, Aupito William Sio).
[262] (27 May 2020) 745 NZPD per Aupito William Sio.
[263] Overseas Investment Act.

C The United States – Delaware

By contrast to the earlier considered jurisdictions, US law permits the use of takeover defences subject to review by Courts. The State of Delaware, with the largest concentration of registered companies, has arguably the largest body of jurisprudence on takeover defences. There defences are regulated by a combination of federal legislation[264], state legislation, and state courts.[265] Delaware specifically relies on a combination of common law and the Delaware Code.[266] Takeover defences are permitted to the extent that they are a reasonable response to the threat posed by the takeover.[267] This broad position is contained in the Delaware code and has been developed by Courts in two key cases.

In *Unocal Corporation v Mesa Petroleum Co (*the *Unocal* case*)* the Delaware Supreme Court set out a 'business judgement rule'.[268] The starting point for the court was the board's fiduciary duty to act in the best interests of stockholders.[269] Although the board has broad powers to do so those powers are subject to restrictions and do not give a board unbridled discretion to defeat takeover bids. When assessing whether an anti-takeover measure is a legitimate exercise of directors' powers the courts will have to determine whether the defensive tactic was a reasonable response to the perceived threat.[270] Legitimate threats which may justify defensive action include inadequate offer price, nature and timing of the offer, potential illegality, and effects on stakeholders.[271] The Supreme Court also added the caveat that motive for the defence must be a 'good faith concern for the welfare of the stockholders' free from fraud and misconduct.[272]

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[264] Securities and Exchange Act 15 USC § 78a.
[265] William J Carney *Mergers and Acquisitions* (2 ed, Foundation Press, New York, 2007) at 923 to 1051.
[266] General Corporation Law 8 Delaware Code § 101 to § 398.
[267] Dibley, above n18, at 39.
[268] *Unocal Corporation v Mesa Petroleum Co* 493 A 2d 946 (Del SC 1985).
[269] At 955.
[270] At 955.
[271] At 955.
[272] At 955.

This *Unocal* test was refined in *Revlon, Inc. v MacAndrews & Forbes Holdings, Inc (Revlon)*.[273] The Supreme Court once again recited the principles that managers had responsibility for managing a business and must act in accordance with their fiduciary duties of care and loyalty.[274] Even when responding to a threat the principles of 'care, loyalty and independence' must first be satisfied.[275] According to the Court in *Revlon* directors must show firstly that they had reasonable grounds, based in good faith and reasonable investigation, for believing there was a danger to corporate policy or effectiveness.[276] Secondly they must show that their actions to block an unsolicited takeover offer were a reasonable response to the perceived threat.[277] Where directors have satisfied the court that the business judgement rule applies there is a presumption that the decision was made on an informed basis, in good faith, and with an honest belief that it was in the best interests of shareholders.[278] In the wake of *Revlon* certain defences are permitted, provided they can satisfy the modified *Unocal* test.

US companies have relied heavily on takeover defences in response to COVID19. This can be seen in the uptake of just a single type of defence, the poison pill or shareholder rights plan.[279] This can significantly increase the cost to acquire a controlling stake and as a result discourage hostile bidders. Between March and May 2020 45 firms across a wide variety of industries had announced the adoption of poison pills. By comparison in 2019, only 25 S&P 500 companies *in total* had active pills.[280] This has allowed firms to respond rapidly and effectively to the increased threat of COVID driven takeovers. It is clear that such plans are seen as a potent tool for warding off opportunistic activist investors.[281]

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[273] American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (American Law Institute, Minnesota, 1994) Parts I-VI at 405-406.
[274] *Revlon, Inc. v MacAndrews & Forbes Holdings* 506 A 2d 173 (Del SC 1986) at 179.
[275] At 180.
[276] At 180.
[277] American Law Institute, above n273, at 406.
[278] *Revlon Inc v MacAndrews & Forbes*, above n274, at 18.
[279] Eldar and Wittry, above n59.
[280] Eldar and Wittry, above n59.
[281] Shim, Langston and Allen, above n15.

What is important about Delaware's legal regime is that the protections it provides against opportunistic hostile takeovers are much more comprehensive in scope that those offered by the jurisdictions examined with a 'no frustration' rule. In the UK[282] and Australia[283] the lack of defensive measures is offset only by legislation offering limited powers of scrutiny over bids from a limited subset of investors for a limited subset of companies. In response to the increased risk of hostile takeovers arising from the COVID 19 economic crisis, those jurisdictions have done little more than increase the availability of the relevant power of scrutiny. For many companies this provides little protection from increased takeover threat. New Zealand has unfortunately taken a similar approach. What is particularly striking is that these responses appear to recognise that there is an increased threat of takeovers.[284] Of what appear to be the two major alternatives available, legislative reforms versus allowing defences, the US Delaware regulatory model which allows the use of takeover defences provides more comprehensive protection by comparison by being available to all companies versus all potential bidders.

VI The Case for Takeover Defences

A The Need for Defensive Measures

As the foregoing discussion shows, the economic arguments for the 'no frustration' rule are not so strong or determinative of the debate as regulators and legislators seem to think.[285] The claim that takeovers promote resource allocation efficiency for instance is a strong argument in theory. Poor use of resources should reduce a company's share value. However, the agency costs argument is somewhat weaker in that it relies on the questionable assumption that management failures alone can account for a sufficient discount to make a company vulnerable to a takeover.[286] Both of these arguments are challenged by evidence that well performing companies are often targeted for takeovers

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[282] The Enterprise Act (UK).

[283] Foreign Acquisitions and Takeovers Regulation (Cth).

[284] See for example: Department for Business, Energy & Industrial Strategy and Sharma, above n57; French, Irwin and Ralston, above n57; Walters, above n57.

[285] See: Dibley, above n18 at 18-23.

[286] Coffee, above n10, at 1201.

and poor performing ones often are not.[287] Meanwhile, while there is evidence that companies and shareholders derive value from takeovers, there remains a concern that some portion of that arises not from improved productive efficiency but rather from imposing costs on stakeholders and other shareholders.[288] There is a great deal of uncertainty here. All of this is before considering the effects of COVID 19. The risk of undervalued share prices undermines the underlying assumptions of the resource allocation and agency costs arguments because failures of resource allocation or management are unlikely to be the key drivers of reductions in share value.[289] Constant takeover threats may even reduce managerial effort.[290] Overall while the economic arguments for the ‘no frustration’ rule appear persuasive, a closer examination reveals a great deal of contention.

Even in absence of economic arguments, proponents of the ‘no frustration’ rule rely on shareholder sovereignty to justify the prohibition on defensive tactics.[291] On the one hand the importance of shareholder sovereignty as a principle cannot be overlooked. In New Zealand it is broadly recognised in both common law and in regulations.[292] However, that same sovereignty can at times risk shareholders’ decision making biases or lack of information being exploited to their detriment.[293] It can also lead to wide ranging harm to stakeholder interests which are increasingly being recognised as important both to the company and from a corporate governance standpoint.[294] The problem is only made worse in times of economic crisis where depressed share values, informational asymmetries, and shareholder irrationality can be exploited by bidders to the detriment of both shareholders and stakeholders. The need to protect both of these groups is a factor weighing heavily against the principle of shareholder sovereignty.

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[287] Franks and Mayer, above n119; Coffee, above n10.

[288] Guest, Bild and Runsten, above n125; Davies, above n11, at 543.

[289] Coffee, above n10.

[290] Haan and Riyanto, above n107.

[291] Bebchuk, above n109.

[292] *FXHT Fund Managers Ltd (in Liq.) v Oberholster*, above n67; Companies Act, s 133; Takeovers Regulations, r 39.

[293] Bainbridge, above n112; Kahneman and Tversky, above n56.

[294] Davies, above n11.

Takeover defences themselves can be valuable for enabling management to better protect shareholder and stakeholder interests. Implementing takeover defences, in theory at least, can go some way towards addressing the risk of shareholders being exploited by giving management the power to negotiate where low offers are made for a company in reliance on shareholders being too risk averse to decline it.[295] Even in absence of bargaining effects there is evidence that defences allow management to focus on more long term projects and in doing so improve shareholder value.[296] Furthermore, when freed from the threat of takeovers, management is better able to look after the interests of stakeholders which can in turn improve returns for both the company and shareholders alike.

Finally, the responses of New Zealand, Australia, and the UK, three jurisdictions with some form of 'no frustration', are characterised by a glaring lack of protection for 'non-sensitive' companies and companies subject to domestic takeover pressures. The responses focus on national security interests and the risk of foreign takeovers.[297] This response is useful for highlighting two key points. Firstly, there is broad recognition that the stock price declines caused by COVID 19 leave companies vulnerable to undesirable takeovers. Secondly, it demonstrates that when there is an economic crisis the protections for companies with depressed stock market values is insufficient. The US model which allows the use of defences, by comparison, highlights just how valuable a tool defences are perceived to be by corporations. Allowing defences has enabled US companies to respond quickly, effectively, and comprehensively to what all jurisdictions appear to have realised is a threat.

Yet even these criticisms of the existing New Zealand regime and its rationales are not determinative. Outside of the context of an economic crisis, there is evidence that takeovers can promote economic efficiency. The shareholder sovereignty principle cannot be permanently set aside simply because it may at times be harmful. Concerns of managers potentially abusing takeover defences to entrench themselves cannot be overlooked. What

[295] Davies, Hopt and Ringe, above n143.

[296] Chemmanur and Tian, above n165.

[297] See for example: Department for Business, Energy & Industrial Strategy and Sharma, above n57; French, Irwin and Ralston, above n57; Walters, above n57.

is necessary is a regulatory regime which balances all of these concerns and ensures that companies have some way to protect themselves, shareholders, and even stakeholders from the increased risk of opportunistic hostile takeovers in times of economic crisis. At the same time any regime must also be careful to ensure these defences are used only for proper purpose and for the benefit of the aforementioned shareholders, stakeholders, and the company itself.

B Proposals for Reform

3 Ex Ante Approval

The ex-ante strategy proposes allowing companies who wish to take overtly defensive actions to do so provided they can get approval from the Takeovers Panel. In times of economic crisis this approach would allow corporations who believe themselves vulnerable to seek a special exemption from the Panel to allow them to implement a defence such as a poison pill for example. The Panel may then either grant or decline the sought exception depending on the Panel's assessment of directors' reasoning for wanting to implement the defence. This method is already contemplated in some form by r 39(c) of the Takeovers Code which allows directors to take defensive actions "for reasons unrelated to the offer".[298] Although the existing provision would presumably exclude actions taken expressly to frustrate a takeover bid, it shows that determining the legitimacy of potentially frustrating actions is already within the ambit of the Panel's responsibilities. This proposal would simply expand what the Code considers to be permitted. An alteration to the existing rule to remove the phrase "for reasons unrelated to the offer" would be sufficient to enact the strategy proposed here.

This strategy would be both simple to implement and broadly consistent with existing policy. According to the Takeovers Act the Takeovers code can be amended by advice from the Panel to the Minister of Commerce to in turn recommend the alters regulation to the Governor-General.[299] The fact that it would only involve a minor expansion of the

[298] Takeovers Panel, above n33.

[299] Takeovers Act, s22; Beck, Borrowdale, Buchegger, Campbell, Foley, Goddard, Jones, McArley, McDonald, Gordon, Shapira, Walls and Watts, above n16, at [43.3].

Panel's powers whilst maintaining a default stance of prohibiting defensive action keeps it more in line with the policy objectives of the initial prohibition.[300] This alteration would enable defences to be utilised but restrict such utilisation to times where the Panel deemed it appropriate; presumably in times of massive economic downturn. By default, defences would remain prohibited. This ex ante approach would effectively uphold the need to ensure that defences are not being exploited by management to entrench themselves and the importance of recognising that barring exceptional circumstances the shareholder sovereignty principle should be upheld. At the same time, it enables those interests to be balanced against the need to protect shareholder, stakeholder, and company interests in times of economic crisis.

In practice this approach also has the advantages of expertise and efficiency. The Panel is formed of industry professionals and other expert individuals. These panel members may potentially be better able to detect whether the proposed defensive action is in truth motivated by a crisis induced takeover threat or whether the crisis is being used as an excuse for said action.[301] This approach also manages to avoid the time and cost associated with litigation. As such it can be said to be more efficient. When initially recommending the 'no frustration' rule the Panel expressly noted that an ex post review strategy, like that implemented in the US, would likely increase litigation costs and uncertainty for all parties involved.[302]

The key limitation of this strategy is that it would only apply to code companies. Closely held and privately traded companies are not covered by the Code. Instead they fall under the regulatory regime contained in the Companies Act.[303] Under that Act directors may only use their powers for a proper purpose.[304] According to case law, frustrating takeover bids cannot be a proper exercise of power as it would deprive shareholders of a

[300] Hare, above n2, at 782.
[301] Dibley, above n18, at 43-45.
[302] At 20-21.
[303] Companies Act.
[304] Section 133.

'constitutional right'.[305] As a result of this either the Courts would need to treat the Code amendments as a legislative signal or further reforms to the Companies Act clarifying that defences can be a legitimate exercise of power would be necessary. Otherwise there could be the somewhat strange situation where directors of some companies have access to takeover defences while others, which may be equally or more at risk during an economic crisis, do not.

4 Ex Post Review

The second proposed strategy would allow the use of defences subject to review by the courts should they be challenged. This would likely follow the example of the American system.[306] Of the two proposed methods this is more controversial as it would by default allow the use of takeover defences. Perhaps the key criticism of the ex post approach is that New Zealand would return to the common law which was thought insufficient prior to the introduction of the Code. In the particular context of this paper there are also some concerns that management may use an 'economic crisis' as an excuse to block a takeover which would objectively be good for shareholders and other stakeholders.[307]

The primary problem with this strategy is that it does not align with policy. Although the Courts would likely be capable of adjudicating the legitimacy of takeover defences, returning that role to the Courts is directly counter to the policy objectives driving the original takeover law reforms.[308] Specifically there were concerns that a US style system as is proposed here would increase litigations costs and due to being an ex-post review also increase uncertainty.[309] This method would also likely be slower than an approvals process simply due to the time it takes for litigation. By allowing defences as a default, this approach may enable defences to be implemented for improper purposes and relied on until they are successfully challenged in Court. Furthermore, it would change what is New Zealand's current default position on the use of defences.

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[305] *Hogg v Cramphorn Ltd*, above n70, at 268.
[306] American Law Institute, above n273.
[307] Bebchuk, above n109.
[308] Dibley, above n18, at 20-21.
[309] At 21.

Implementing this strategy would require significant reforms. Under this approach rules 38 and 39 of the Takeovers Code would need to be abolished.[310] Presumably defences would then be regulated by the legal regime in place prior to the implementation of the Code. As discussed previously, the Companies Act s133 has been interpreted as prohibiting defensive tactics.[311] This is regardless of whether the decision is motivated by a belief in good faith that the defence was in the best interests of the company.[312] In order to implement this strategy the Courts would either have to take the abolition of rules 38 and 39 in the Code as a legislative or regulatory signal or the Companies Act would need to be reformed to clarify the scope of 'proper purpose'.[313] The advantage over the ex-ante strategy is that once these reforms are enacted the same legal regime in this regard will apply to all companies.

VIIConclusion

The market for corporate control serves as an important tool for ensuring economic efficiency and promoting effective corporate governance. In an efficient capital market takeover threats can help manage agency costs. Takeovers can improve resource allocation efficiency or generate value for shareholders. As well as promoting economic efficiency, a market for corporate control upholds the fundamental principle of shareholder sovereignty. Under those arguments the value of takeovers provides a strong argument in favour of a no frustration rule. However, most of these rationales rely on a strong underlying financial market where share prices are a semi-strong reflection of a company's true value.

The COVID 19 economic crisis highlights some of the shortcomings of these rationales. Severe undervaluing during an economic crisis means failures of management or resource allocation are unlikely to be major drivers of discount driven takeover bids. There may be no inefficiency for an acquirer to remedy. There may not be any fault of management to

[310] Takeovers Regulations, r 38.
[311] Companies Act; *FXHT Fund Managers Ltd (in Liq.) v Oberholster*, above n67.
[312] *Hogg v Cramphorn Ltd*, above n70, at 265.
[313] Companies Act , s 133.

sanction. Meanwhile as a result of informational asymmetries, uncertainty in the market, and shareholder biases, the sovereignty principle potentially becomes akin to tacit endorsement of shareholder exploitation. Furthermore, the risk of negative externalities demands some remedy. Legislative responses simultaneously show a recognition of the problems created by an economic crisis as well as a general lack of impetus to respond to those problems.

This paper makes a case for a limited exception to New Zealand's 'no frustration' rule in times of economic crisis. During a crisis such as COVID 19 both the pandemic itself and public measures to address it have created a severe risk of companies being undervalued. This undermines the traditional arguments in favour of the rule. Shareholder sovereignty remains important but there is a need to address the risks of exploitation and negative externalities. Ultimately what is needed here is a balance. One which upholds the policy objectives behind the original prohibition and ensures that defences are only used for proper purpose, but at the same time enables companies to take defensive actions to protect themselves, their shareholders, and their stakeholders when necessary. The most effective way to balance these interests would be to allow the Panel to grant specific exemptions to companies who wish to utilise defences for the proper purpose of protecting company, shareholder and stakeholder interests during an economic crisis.

With many countries already showing signs of recovery from the COVID 19 pandemic, perhaps it is already too late for this crisis. However, even as life returns to normal, it is likely the economic consequences will be felt for some time to come. Economic crises do not occur infrequently; the next may already be on the horizon. Reform is needed both in case of a resurgence, and in preparation for the next crisis to come.

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