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Journal of Finance Research
https://ojs.s-p.sg/index.php/jfr

REVIEW

The UK Non-Frustration Rule: Should it be Replaced with a US-inspired Approach?

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ARTICLE INFO

Article history
Received: 27 November 2019
Revised: 4 December 2019
Accepted: 9 April 2020
Published Online: 16 April 2020

Keywords:
UK Takeover Code
Non-Frustration Rule
"Poison Pill"
Takeover Defense

ABSTRACT

Recently, Arm Holdings, the most successful semiconductor and software design company in the UK, has agreed to be sold to SoftBank, a Japanese company. This takeover case, along with the case that Cadbury was acquired by Kraft in 2010, has led to questions about the openness to foreign mergers and acquisitions.[1] The non-frustration rule plays an important role in the openness of the UK's market for corporate control.[2] Therefore, it is time to rethink about the non-frustration rule. One of the most heated questions is whether the rule should be replaced with the US-inspired approach. This article argues that the US-inspired approach will not function as well in the UK as it does in the US. After all, the UK and the US differ a lot in corporate structures and company regulations which make the background of the non-frustration rule different in two countries.

1. Introduction

The non-frustration rule is evaluated as a "keystone rule" in the UK Takeover Code[3] In the UK, the managers of companies are subject to the non-frustration principle, in which without the special power given by the shareholders, the only way allowed to reject a hostile takeover is to search for a third party, the "white knight"[4], to make a better offer.[5]

In 1959, the non-frustration rule was firstly stated in the Notes on Amalgamations of British Businesses[6] Later, in 1968, the first takeover code set forth the rule in depth and it had remained almost the same afterwards. Today, the non-frustration rule is presented in General Principle 3 of the UK Takeover Code as, "the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid."[7] Furthermore, Rules 3 and 21 of Takeover Code also elaborate this rule. It can be found in Rule 3.[8] that, the target board is required to remain silent during the bid. The board is prohibited from making any recommendation for the shareholders on whether to accept the offer or not[9]. The Rule 21 sets down a list of situations to illustrate when the shareholders' approval are required.[10] The situations include share issues, acquisitions, disposal of the company's assets, etc.[11] It was argued by Professor Davies that, this rule does not necessarily prohibit actions which have frustrating effects. It rather emphasizes that these actions

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DOI: https://doi.org/10.26549/jfr.v4i1.2922

must be "placed firmly in the hands of shareholders during the general meeting".[12] According to Rule 21 and 34, the non-frustration rule will come into effect when a bid is made or when the company has a reason to believe that an offer might be imminent.[13] As such, corporate actions taken prior to the offer would not be prohibited.

In the UK, the non-frustration rule is highly supported by business persons, scholars and practitioners. J Plender states in his article that, the US approach is toxic when compared to the UK regulations. The UK approach ensures that the market is under control, which is fair for shareholders.[14] Support for this regulation is based on several rationales. Firstly, the non-frustration rule protects shareholder sovereignty. To be specific, shareholders have the right to decide whether to sell their shares or not.[15] Secondly, under this rule, the board of a company has less chance to take action for their own interests. Furthermore, it helps with solving agency cost problems.

Unlike the regulations in the UK, the US takeover law is quite different, especially in the aspect of takeover defense. In most American states, company management has considerable discretion. It is lawful and common for them to take actions when an offer is imminent.[16] It is believed in the US that, although management may be entrenched through takeover defenses, they can bring some positive effects.[17] First, since there are takeover defenses, the board of directors have the right to control the sale process and determine sale strategies. A controlled action is highly likely to result in a better premium.[18] Second, the regulations in the US give company management more time to search for a third party which can provide a higher offer. Third, the actions the management take can prevent some shareholders, especially uninformed ones, from selling their shares at a low price.[19] Last, the defenses may enable the company to obtain a price better than the board's reservation price.[20]

The UK and the US rules share little in common, they have their respective advantages and rationales behind them. When inquiring whether the UK non-frustration rule should be replaced with the US approach, positing a UK legal world without Rule 21 of the Takeover Code is a good choice.[21] Without Rule 21, under the UK company law's mandatory rule, the defensive discretion for the board of directors is constrained.[22]

2. Takeover Defenses in the Absence of the Non-Frustration Rules

In the United States, the state corporate law allow a company to take both generally applicable and company-specific board-controlled defense actions.[23] There are mainly five types of takeover defense in the US. This article outlines the five types and discuss about whether they are available and practical in the UK legal world where there is not any non-frustration prohibition.

The most potent and prevalent defense in the US is the "poison pill". The shareholder rights plan (poison pill) "involves warrants issued by the target company to existing shareholders to purchase equity in the target company (flip-in plan) or in the bidder should a successful bidder merge with the target (flip-over plan)."[24] Until there is a triggering event, the warrants approved by the board do not have any economic value. The triggering event always occurs when a bidder crosses the ownership threshold without the approval of board of director.[25] The law provides the board with the right to redeem the warrants, and the tender offer cannot proceed unless the board does so. The poison pill can be put in place anytime, even after a tender offer has been announced and the shareholder approval is not yet required. However, it is not possible to make a warrant without shareholder approval in the UK under the non-frustration rule.[26] Even if the non-frustration rule is abolished, in order to issue the warrant, a general meeting is still required, because the shareholders have to provide the management with the authorization to allow the warrant in a general meeting.[27] Apart from the problem mentioned above, another problem with regard to the availability of the poison pill in the UK arises from rules of the United Kingdom Listing Authority (UKLA). The principle 5 of the UKLA rules that "for listed companies holders of the same class of shares be treated equally in respect of the rights attaching to such shares."[28] When the shareholder rights plan is allowed, the bidder is unable to purchase the shares at a discount, which may be viewed as discriminatory by the UKLA and under that case the poison pill would not be available to the UK listed companies.

Regardless of the availability that poison pill can be applied to the UK legal system, the effect of this approach will not be as good as it is the US. In the US, the board of directors can be removed without cause and at any time, and it also allows the boards to have staggered three-year term and be removed only for the cause during the term.[29] Besides, whether or not an interim meeting can be called during the terms depends on the company constitution.[30] In contrast, in the UK, the board term is usually one year and shareholders have the right to call interim meeting.[31] All in all, the board in the UK under the shareholder rights plan have far less power when compared with the board in the US.

The second type of defense in the US is business combination defense. When a bidder crosses the threshold

 DOI: https://doi.org/10.26549/jfr.v4i1.2922

without the board approval, the business combination defense comes into effect, which limits the bidder's ability to purchase the target company, often through a merger.[32] In the UK, the business combination defense can be applied in three situations. It can be placed at the IPO stage in the corporate constitution. The defense is also available prior to the bid or whenever there is shareholder approval. The business combination defense is used to fight against the unwelcome suitors. However, in the UK, the shareholders have the right to remove the board of directors or suggest the board that the bidder is not an unwelcome one. Thus, this defense would be ineffective in the UK legal world.

The third defense is the restructuring defense. The Delaware state in the US is a good example to illustrate this approach. In Delaware, the board of directors can provide a third party with a substantial block of shares without shareholder approval.[33] Under a certain circumstance, the shareholder approval is required; that is when the company is listed on the New York Stock Exchange while it shares a large number of outstanding voting shares.[34] The Delaware companies have flexibility to make interim dividends.[35] By contrast, UK companies are facing more restrictions. A company can issue shares to a friendly third party only "if the company has sufficient authorized share capital, the shareholders have granted authority to allot the shares[36] and, if the shares are issued for cash consideration, the shareholders have misapplied their statutorily imposed mandatory pre-emption rights."[37]

The fourth approach is business decisions with a defensive impact. This defense may be taken because of both defensive impact and business merits.[38] The "crown jewels" defense is one of this kind of defense, which means that the company may sell its key business asset so that the bidder would have no interest of the company. A listed company should follow the Listing Rules' regulation of Significant Transactions.[39] Shareholder approval is required when a disposal amounts to the sale of 25 per cent of the company's assets,[40] while in Delaware, the amount is "all or substantially all".[41]

The last takeover defense is litigation. In the US, bidders have disclosure obligation which is stated in the Securities and Exchange Act 1934[42]. If the bidder fails to comply with the obligation, the defensive litigation can be used.[43] In addition, target companies can commence antitrust litigation if the takeover will cause antitrust injury. Commencing litigation provides the target board with more time to search for a better bidder. Since the mid-1980s[44], when the poison pill was approved, it has been more common for companies to use the pill to get more time in a bid. While in the US, litigation is not the most powerful defense, in the UK, where other defenses are not available or ineffective, whether litigation (in the absence of non-frustration rule) can be available seems to be a rather important issue. Under the City Code on Takeovers and Mergers, which is the predecessor of the Takeover Code, the scope for litigation is limited, because the code is not law.[45] The Panel plays a role of public law and the decisions carried out by the Panel can be the subject to a judicial review. In the case R v Panel on Take-overs and Mergers[46], the Court of Appeal claimed that, it was for the Panel to decide the bid, the court would not intervene in the Panel's decisions[47] The Company Act 2006 rules that, only the Panel is able to apply for injunctive relief[48] Accordingly, even without Rule 21, the target board has no private right under the UK Company Law and Competition Law. The Scope for litigation is still limited.

3. The Background of the UK And the US Takeover Regulations

So far, it has been argued that, even without Rule 21, the US approach is not suitable for the UK legal system. The reason is mainly based on the divergences between the UK and the US corporate ownership structures and takeover law.

In modern society, there are mainly three kinds of problems that current company law must solve. The first one is the opportunism which may rise between board of directors and shareholders. The other two are relationships between controlling shareholders and minority shareholders along with that between shareholders and other company constituencies, to name a few, creditors, and employees.[49] In order to solve these problems, the company law must work with corporate structures. Since the US corporate structure is traditionally described as dispersed ownership structure,[50] the law focuses on problems of opportunism between shareholders and managers.[51] By contrast, the UK companies are always with concentrated ownership, in the situation of which there always exists one controlling shareholder, thus UK company law concentrates on the problem between controlling shareholders and minority shareholders.[52]

In the United States, the Company Law gives more power to the board of directors, while in the UK, more power is given to the shareholders.[53] Thus, a US board of directors has the discretion when facing a bid. However, as is shown in the Company Act 2006, shareholder approval is required in many situations. In addition, it is the directors' duty not to fight unless the shareholders vote. By contrast, in the US, companies are required to fight against hostile takeovers.[54] There are only two situations, in which the directors can be refrained from fighting:

DOI: https://doi.org/10.26549/jfr.v4i1.2922

(i) the offer is a best one for the company; or (ii) if the *Revlon*[55]'s duties triggers, the directors should sell the company to the highest bidder regardless of other considerations.[56]

Apart from corporate structure, another reason leading to different takeover regulations is that, "UK companies' metaphorical doors are wide open for hostile takeovers".[57] The UK companies are more likely to be purchased by foreign companies rather than domestic ones. This has its advantages and disadvantages. The positive side is that, after taken by a non-domestic company, the domestic British companies become part of a more competitive enterprise, thus protecting jobs in long term. On the other side, it is likely for the company to lose its national identity.[58] It is hard to reach a conclusion whether "wide open door" along with the takeover regulation is generally beneficial or not. However, it can explain to some extent why the US approach is not available and effective in the UK.

4. Conclusion

The non-frustration rule plays a key role in the UK Code. In the 1950s and later, the public concerned about the boards' use of defenses, which might lead to disregard of shareholder rights. Thus, non-frustration rule was created in the Notes on Amalgamations of British Business. The rule balanced the power between the bidder and target board and reinforced the right of shareholder. It also helped in solving agency cost problem.

The defensive actions may produce *ex ante* and *ex post* agency costs.[59] Under the non-frustration rule, the target board is likely to believe that a better performance of the company can help to avoid hostile bidders. On the other hand, if the board of directors has discretion, they will assume that, the vote power would help them retain control even when a hostile bid commences. Accordingly, the takeover threat will lose disciplinary function and the agency cost will occur.[60] In addition, the agency cost will occur when there is divergence of interests between the shareholders and the board. Giving the decision-making right to the shareholders instead of board of directors is a good solution to agency problem.

As mentioned above, abolishing the non-frustration rule and using the US-inspired approach instead cannot provide the board of directors with free rein to take defensive action. Shareholder approval is required to create the defense in most cases and when it comes to using the defense, shareholder approval is required under all circumstances. The non-frustration regulation is a part of the UK company law. The law aims at protecting the right of shareholders, so does the non-frustration rule. Thus, if Company Act does not make adjustments, the change of non-frustration rule is ineffective.

The economic environment in the UK is changing rapidly, however, the non-frustration rule has remained the same for a long time. It is time to rethink about this regulation. There are other possible solutions apart from using US approach. Firstly, increasing the acceptance threshold is a possible way which does not disturb the existed regulations.[61] The second is the disenfranchisement of short-term shareholders. Thirdly, enhancing the Government power, either to obtain enforceable undertakings or block a takeover will also result in a better-ordered market.[62]

Using the US approach is not effective because it offers little defensive power under UK legal system. Although the non-frustration rule does have some side effects, unless a solution which fits in UK legal system has been worked out, it is better to maintain the rules unchanged.

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