Protecting Fangxin Biotechnology Company from a hostile takeover

Master thesis

Submitted to:
University of Twente,
Enschede, the Netherlands

Supervisors:
Dr. R.A.M.G.Joosten
Ir. Hank Kroon

Author: Yilin Song
Student No: S1001132
Study: MSc Business Administration
Specialization: Financial Management
School: Management and Governance
Date: 23/01/2012

Acknowledgement

This thesis is conducted in the department of business administration with the contribution from the Fangxin Biotechnology Company.

I would like to acknowledge the contributions from several important people for finishing this thesis.

First, I would like to express thanks to my supervisor Dr. Joosten at University Twente, for his guidance and support during the whole process of writing this thesis.

Secondly, I would like to express my gratitude to the staff of Fangxin Biotechnology Company who provided information about the company to me and supported me for the data collection.

Third, I am indebted to my family members who supported me during the completion of this thesis.

Summary

Mergers, acquisitions and takeovers have been hot topics in the business world for recent years. Takeovers refer to transfer of control of a company from one group of shareholders to another. Friendly takeovers occur when the managements of the two companies make an agreement that is agreed by both sides. Unlikely friendly takeovers, hostile takeovers refer to a bidder trying to take over a company against the will of the management, shareholders and board of directors of the target company. Up to now, more and more the companies are facing the risk of being a target for a hostile takeover. Nowadays, many companies are trying to protect themselves from possible threats. The purpose of this thesis is to describe and analyze different defense tactics by conducting case studies, in order to find out what kind of defense tactics can be applied.

In this thesis, we focus on a hostile takeover in Chinese biopharmaceutical industry. In 2011, Fangxin Biotechnology Co., Ltd and Maker Biotechnology Co., Ltd talked about the possibility of merger. However, Fangxin rejected such a proposal, because it realized that the purpose of Maker was to take of core technology from Fangxin. However, Maker did not give up and launched a bid for Fangxin, which was rejected by Fangxin. In this thesis, a qualitative method will be used. In order to reach a deeper insight in the chosen subject, we have decided to use case studies that will be carried out to investigate defense tactics that can be used by Fangxin Biotechnology Co., Ltd.

Due to the different legal systems and regulations, it is hard to generalize a tactic that is universal and suitable for all companies in the world. After analyzing the feasibility of various well-established defense tactics under Chinese regulations and laws, only litigation and white knight are suitable defense tactics for Fangxin. Because Maker did not follow the compulsory obligation to announce the tender offer in the public place, therefore, Fangxin can submit this case to the local court and start a suit in a law court. This tactic helps Fangxin to extend the negotiation period with Maker. Fangxin can find a friendly third party to rescue itself from this takeover. As mentioned above, Ketai can take a “white knight” role, Fangxin either can be bought by Ketai or Ketai can outbid Maker at the tender offer. So Fangxin can apply either litigation or white knight to go against this takeover. Moreover, we find that white squire and Pac-man also can be applied in this case. In order to raise the effectiveness of defense tactics, we provide the possible combination of defense tactics such as litigation and white knight/squire or litigation and pac-man.

Fangxin can adopt some defense tactics to resist future takeovers. These tactics are called as prevention defense tactics that are applied before the threat of takeover. After analyzing the feasibility of prevention defense tactics under Chinese law, golden parachute and stagger board of directors can be implemented by Fangxin.

Table of Contents

Appendices

List of Figures and Tables

Tables

1. Introduction

The first chapter introduces the problem behind the research purpose. In this background, a comprehensive description of Mergers and Acquisitions (M&A) and takeovers is presented. A problem definition follows by the background where the research questions and objectives are generated. The thesis structure will be presented at the end of this chapter.

1.1 Background

Mergers, acquisitions and takeovers have been a part of the business world in 21 centuries. In the past years, these three words have been highly discussed topics in business media and newspapers. The phrase Mergers and Acquisitions (M&A) implies that a large numbers of different transactions such as purchase and sales of undertaking, two companies entering into an alliance, etc. (Hitt, 2001). A merger can be treated as a process when two companies join into a new company. In this new company, they mix their assets and liabilities (Hussey, 1999). An acquisition is a process which one company takes over the control of another through stock and shares purchase (Schweiger and Very, 2003).Nowadays, a great wave of M&A transactions are taking place in China. In 2010, Chinese companies spent $ 14.2 billion on the M&A activities[1]. According to the report of Zero21PO Research Center, the total M&A value in the Chinese Market reached to $34,802 million in 2010. M&A in China reached 10% of the global M&A market in 2010, also took about 23% of M&A market in Asia[2]. All these figures demonstrate that China has become the biggest M&A market in Asia.

According to Mayer and Jenkenson (1994), takeovers refer to transfer control of one company from a group of shareholders to another one, and takeovers can be friendly

1. China Business News: June 26, 2011
2. China Daily: January 18,2011

or hostile takeovers. Friendly takeovers occur when the executives of the two companies work out an arrangement that is agreed by both sides. Unlike the friendly takeovers, hostile takeovers do not involve any friendly negotiations and transactions within two companies, one company (a bidder) trying to take over another (a target) which goes against the will of its executives, the shareholders and the board of directors (Pearce and Robinson, 2004).

Till now, hostile takeovers have been penetrating into different countries in the world. More and more companies are running the risk of being a target for a hostile takeover. Many of them are trying to protect themselves from potential threats. Due to the different legal systems and regulations, it is hard to generalize a perfect defense tactic to repel a hostile takeover, because every takeover is unique. In this thesis, we focus on a hostile takeover case in the Chinese biopharmaceutical industry.

1.2 Problem discussion

Before describing the problem of this thesis, general information about two companies will be presented.

1.2.1 Company background

Fangxin

Fangxin Biotechnology Co., Ltd[3] was established in October, 2003 in Zhengzhou City, China. The original registered capital was 6 million RMB and the total assets of Fangxin were RMB 23.7 million in 2010. There are 21 types of products produced by Fangxin, including monoclonal antibody, polyclonal antibody and various testing reagents. Only one product achieved the GMP[4] certification from State Food and Drug Administration (SFDA)[5] ---two-in-one drugs testing reagent[6] which tests morphine and methamphetamine in one time. In 2005, Fangxin started a long-term cooperation with ASIO Pharmaceuticals Company[7] to gain the exclusive right to use its patent in Asia.

The executive headquarter is located in Zhengzhou industrial district. The research and development (R&D) and experiment centers, manufacturing department of diagnostic reagent with GMP-certified are also located in Zhengzhou. The sale, distribution and marketing departments are located in Beijing, China. Fangxin is an unlisted company.

Maker

Maker Science and Technology Co., Ltd was founded in 1994 in Chengdu City, China. In December 2009, it changed the name to Maker Biotechnology Co., Ltd[8]. Maker devotes itself to researching and applying the bioengineering and biotechnology, and focus on the production of quality diagnostic products. The main products include biochemistry reagents[9], immunoassay reagents[10], hemostasis reagents[11], calibrators[12] and so on. Nowadays, over 100 SFDA licensed diagnostic products are produced and sold throughout China. Till now, Maker is an unlisted company.

3. Fangxin Biotechnology Co., Ltd will be referred to as Fangxin hereafter.
4. GMP certification: GMP refers to good manufacturing practice. Experts from the State Food and Drug Administration check the entire process that corporation have involved and assessed whether reach the standard.
5. State Food and Drug Administration will be referred to SFDA.
6. Two-in-one testing reagent can test morphia and methamphetamine in urine as the same time. The picture can be found in the appendix 2.
7. ASIO Pharmaceuticals Company was established in 1998, which located in San Diego, California.
8. Fangxin Biotechnology Co., Ltd will be referred to as Fangxin hereafter.
9. Biochemical reagent is known for the identification of certain metabolisms. It often used to identify microorganisms and its result is seen by color change.
10. An immunoassay reagent is a biochemical test that measures the presence or concentration of a substance in solutions that frequently contain a complex mixture of substances. Analytes in biological liquids such as serum or urine are frequently assayed using immunoassay methods
11. Hemostasis reagent is a medical blood coagulation reagent, which is used in testing the tissue thromboplastin.
12. Calibrator is a comparison between measurements – one of known magnitude or correctness made or set with one device and another measurement made in as similar a way as possible with a second device.

1.2.2 Problem definition

In May, 2011, Fangxin and Maker talked about the possibility of merger. Maker evaluated Fangxin's performance before the merger. Maker chose Fangxin with following reasons. First of all, Fangxin cooperated with ASIO Pharmaceutical Company and achieved the exclusive right to use a new technology patent of ASIO in Asia. Second, it had a two-in-one drugs testing reagent which got GMP certification from SFDA. Third, it also gained the supports from Henan Bioengineering Research Center and local government. Meanwhile, Fangxin also found out the attractiveness of Maker. It has mature technique to produce and market various diagnostic products, has good quality management system, advanced innovation capability etc.

This merger can bring some advantages such as increasing market shares and competitive advantage, raising more customers and suppliers etc. it also reduces the competition in this industry, etc. Fangxin also considered the disadvantages of this merger. It can create a conflict of objectives, direction, strategies between these two companies, the decisions are harder to make and easy to cause disruption in the running of business. Due to the different corporate cultures, it also creates a conflict between two set of workers from entirely different companies. This merger can lead to redundant workers, especially at management level, because the job roles, positions are overlapping. It can also damage the motivation of staff for both companies. Besides, Fangxin is afraid that Maker uses the patent for other purposes[12]. Because it is common issue that one company uses the merger as an excuse to transfer the core technology of the other company. We summarize the advantages and disadvantages of this merger in Table 1.

13. In China, more and more companies are using mergers as excuses to transfer the core technology. The recent case happened in 2010 between Shandong Linhan Biotechnology Company and Shandong Kaisa Biotechnology Company that are merged in 2009. Kaisa set up a new company in another province and used Linhan's patent to produce illegal products

Advantages	Disadvantages
Increasing market shares	Increasing conflicts between objectives, decisions, etc.
Rising competitive advantage	Leading to redundant workers
Rising customers and suppliers	Using patent for other purposes.
Sharing resources	A conflict between two corporate cultures

Table 1 summary of the advantages and disadvantages of this merger.

After balancing the advantages and disadvantages of this merger, this merger is not approved by all the shareholders in Fangxin, because the disadvantages of this merger affect the future value and breaches the development of Fangxin. Besides, Fangxin is afraid that Maker uses its patent for other illegal purposes. Therefore, Fangxin rejected this proposal.

However, Maker did not give up and launched a bid for all the shareholders of Fangxin. The bid was RMB 25 million, which is higher than the total asset of Fangxin (the total asset of Fangxin is RMB 23.7 million). However, Fangxin felt that the bid was far too low and underestimated the future value of the company. Hence, Fangxin rejected this bid too. However, Maker continued to pursue it and raised the original bid. Right now, the bid was RMB 29.7 million. After several shareholders' meetings, the management of Fangxin considered that this takeover can be treated as a hostile takeover and Fangxin is going to resist this takeover.

1.3 Research objective and questions

Against this background of the hostile takeover, this thesis aims to help Fangxin to repel this hostile takeover and provide some suggestions for Fangxin to itself particularly. The research objective is formulated as

"***To find suitable defense tactics enabling Fangxin to fight back a hostile takeover.***"

In order to find out how to protect Fangxin from a hostile takeover, with the research background and research objectives, the central research question can be formulated as follows:

"How can Fangxin Biotechnology Company protect itself from a hostile takeover?"

In order to answer this question, the following sub questions will be analyzed.

- ***What are the motivations behind hostile takeovers?***

  Before we find out the suitable tactics for Fangxin, we like to know the motivations behind the bidder company in advance. Based on these motivations, we can find appropriate tactics to repel a hostile takeover.

- ***What are the common defense tactics against hostile takeovers which are used in other countries?***

  Before the investigation, we want to identify the anti hostile defense tactics. However, there are so many types of defense tactics, it is impossible to define and describe all of them due to the time restriction. Therefore, only a few types will be summarized in the literature review part (section 2.6), which are the most common defense tactics that are used by other countries.

- ***Which defense tactics can be used in China?***

  Due to the different legal systems and regulations, the usage of different defense tactics varies from country to country. Therefore, there is no unique defense tactic for all companies. Therefore, we have to test the feasibility of these common defense tactics under the Chinese's policy.

- ***Which defense tactics or their combinations are suitable for Fangxin Biotechnology Company to repel this hostile takeover by Maker?***

  we can find out the suitable tactic for Fangxin.

1.4 Thesis structure

The thesis is organized as follows. The next chapter presents literature reviews on various aspects of hostile takeovers in worldwide. We analyze previous research on M&A, hostile takeovers, motivations behind takeovers and hostile bids. It also highlights common defense methods that can be applied to prevent hostile takeovers. Further, we will explore whether above mentioned defense tactics can be applied to Fangxin.

The third chapter is dedicated to the methodology. In this chapter, we will describe how to carry out this thesis and to motivate a case study of our choice. This chapter will end up with some discussion about the reliability and validity of the thesis.

The fourth chapter, we will tie the literature review together with the case study. This chapter is devoted to analyze all the defense tactics (section 2.6) under Chinese Law, and explore whether above mentioned defense tactics can be applied to Fangxin.

The fifth chapter of the thesis includes a conclusion and a recommendation for Fangxin. The main focus of this chapter is to state which defense method is most suitable for Fangxin. This chapter ends up with some limitations of this thesis and some suggestions for further research.

2. Literature Review

In this chapter, we cover main aspects that help us to understand hostile takeovers and possible defense mechanisms. The intention of this chapter is to become familiar with aspects mentioned in the previous research that explain defense tactics used in hostile takeover activities. This chapter will end up with different defensive tactics that target companies use to defend themselves from hostile takeovers.

The following topics will be reviewed:

- Mergers and Acquisitions
- Takeovers
- Hostile takeovers
- Takeover bids
- Transfer of shares
- Motivations behind hostile takeovers
- Defense tactics

2.1 Mergers and Acquisitions

The phrase Mergers and Acquisitions imply a large numbers of different transactions such as purchase and sales of undertaking, two companies enter into an alliance, etc. The fundamental purpose of M&A is to enable companies to adjust more effectively to new opportunities and challenges. If M&A activities are done efficiently, they may not only increase market shares, competitive advantage, bargaining position, but also improve company value and profitability (Hitt, 2001).

A merger can be described as a process when two companies join into a new company. These two companies have to mix their assets and liabilities in order to compose a new company (Hussey, 1999). An acquisition can be described as a process that one company acquires the control of another company through stock and shares purchase (Schweiger and Very, 2003).

2.2 Takeovers

A takeover refers to transfer control of one company from a group of shareholders to another one. The purpose of takeovers is to acquire more than fifty one percent of the target company's shares to gain the effectively control. A company that takes over another one is called as a bidder (Ross et al., 2005). There are a variety of reasons why a bidder wants to purchase another company, such as a target company has poor management, or low stock price, a company has excellent capabilities in one area which the acquirer can use for its own product or sever as well. A company may attract the bidder because it explores new market or product. Even a company allows that the bidder to enter a new market without any risk. A company may have mature technology and the acquirer does not have to do such investment again. A bidder may take over a competitor in order to eliminate competition in the same industry. No matter the reasons behind the takeovers, takeovers fulfill the belief that a combined company can create more profit than separate company (Ross et al., 2005).

2.2.1 Hostile takeovers

When one company attempts to take over another it does not involve gentlemanly negotiations and unfriendly transactions. Usually these behaviors go against the will of the target company, this takeover can be defined as a hostile takeover. However, this takeover is usually rejected by the management of the target company (Mayer and Jenkinson, 1994). In a hostile takeover, a bidder company gains the control of a target company through purchasing shares of the target company. In many cases, bidder companies attempt to purchase sufficient shares of the target company to get a majority of the seats on the board of directors (Ross et al., 2005).

However, Frank and Mayer (1996) and Hanly (1992) point out that hostile takeovers have positive effect on target companies. First of all, hostile takeovers are positive for shareholders of the target company. A hostile takeover can replace current management with poor performance, bring a fresh management style to the target company and force managers to increase the value of the shareholders. Second, a hostile takeover reallocates productive assets away from underachieving management team into higher value uses. However, hostile takeovers can also bring negative feeling between the managements and professional groups of the two companies and can easy to create a hostile culture in which integration is difficult to achieve (Hitt, 2001).

2.3 Takeover bids

A takeover bid is also called a tender offer. An acquirer provides an offer to the shareholders of a target company. The tender offer is a public and open offer (usually announced in a newspaper advertisement) which is given by the bidder company, a takeover bid is usually higher than the current market price of the target company and is based on the bidder company's valuation of the target company. The higher price is called bid premium. The size of bid premium depends on the willingness of the bidder company to pay for the target company (Travlos, 1987). According to Mayer and Jenkinson (1998), a takeover bid can be in cash or cash and equity.

According to Travlos (1987), there are two situations to launch hostile bids. First, two companies have been talking about a merger in advance. However, they fail to reach a final agreement. Then one company launches a bid for the other. Such behavior is normally rejected by the management team of the target company. Second, one company launched a bid for another company without negotiation or discussion with the management of the target company first.

2.4 Transfer of shares

The Company Law of People Republic of China (PRC Company Law) provides some Articles about share transfer. Article 72 PRC Company Law stipulates some rules for the share transfer between shareholders of a Chinese limited liability Company (LLC) and for the share transfer from shareholders to non-shareholders. The shareholders may transfer a whole or a part of his/her shares to other shareholders within the company. If a shareholder of a Chinese LLC wants to transfer his/her shares to a non-shareholder, this transfer must gain an approval by more than half of the other shareholders and informs the other shareholders in writing. If the other shareholders have no objection within 30 days, this transfer is deemed to be approved. If half of the other shareholders oppose this transfer, they have right to purchase the shares in advance. Otherwise, this transfer is deemed to be accepted. Besides, Article 72/2PRC Company Law also sets out the preemption right[14] for the shareholders in LLCs in case one of them decides to transfer shares. If one of shareholders decides to transfer his/her shares, current shareholders have the first opportunity to buy these shares before they are offered to a third party.

Article 75 PRC Company Law states that in the following circumstances, a shareholder can transfer shares and request the company to purchase them with a reasonable price. First, the company does not distribute any profit to the shareholders for five consecutive years, though it has made profit and meet the dividend standard. Second, when a company splits up, transfers the main properties, even faces merger. If one shareholder cannot reach a share purchase agreement with the company within 60 days, he/she can file the suit to the people's court within 90 days.

2.5 Motivations behind hostile takeovers

According to Pearce and Robinson (2004), motivations behind hostile takeovers are divided into two types: short-term and long-term motivations. The first type includes short-term motivations such as cash flows, valuable assets[15], etc.

14. Preemption right refers to a contractual right in articles of association or a bylaw which the current shareholders have the first opportunity to buy assets or shares before they are offered to a third party.
15. Valuable assets refer to intangible (patents, copyrights, trademarks, etc.) and tangible assets (buildings, equipments, real estate, inventories, etc.).

Under the short-term motivation, the bidder company does not want to be the owner of the target and is interested in controlling its financial flows or most valuable assets.

Compared with the short-term motivation, the long-term motivation focuses on the long-term benefits and strategic investment. The bidder company is no longer interested in financial aspect. The aim of the bidder company is to penetrate each department of the target company and gain the complete control over the target company such as corporate restructuring etc.

2.6 Defense tactics

This section is devoted to describe common defense tactics that are used in other literature. Based on the different regulations and legal systems among countries, the usage of these defense tactics, it is hard to find a tactic that is universal and can be applied for all the cases.

According to Pearce and Robinson (2004), the objective of these defense tactics is to complicate taking over or make it more costly for a bidder to take over. Besides, defense tactics can be divided into two categories: prevention and reaction defense tactics.

Prevention defense tactics are applied by the target company before a hostile bid is placed (Ruback, 1987). These tactics can create legal and economic barriers to prevent hostile takeovers or block the control of the bidder company over the target company, and can be treated as proactive steps that are taken by the target company to reduce attractiveness as a target (Pearce and Robinson, 2004). Reaction defense tactics can only be adopted after a hostile bid is placed (Pearce and Robinson, 2004) and they are only effective when a takeover offer has been made (Ruback, 1987).

We will discuss the prevention and reaction tactics in details, the first sub-section

(2.6.1) is devoted to the prevention tactics, and the second sub-section (2.6.2) explains the reaction tactics.

Table 2 shows the major difference of two types of tactics.

Prevention defense tactics	Reaction defense tactics
Poison pills	Litigation
Golden Parachute	White knight
Staggered boards of directors	Green mail
	Share buyback
	Standstill agreement
	Scorched earth
	Crown jewel
	White knight
	Pac-man

Table 2 Summary of Prevention and Reaction tactics

2.6.1 Prevention defense tactics

Poison pills

According to Pearce and Robinson (2004), poison pills can be used as a prevention tactic that is best suited for an implementation before a hostile takeover. It was created by an M&A lawyer Martin Lipton in 1982. Poison pills are special rights or securities that a company issues to its shareholders in the event of a takeover. Therefore, it also can be called shareholders rights plan.

According to many researchers, such as Heron and Lie (2006), Weston (2001), Pearce and Robinson (2004), etc. Poison pills have two variants: flip-in and flip-over plans. Flip-in plans enable shareholders of a target company to purchase additional shares in their company. The additional shares are purchased at a substantial discount. However, it is valid only for the original shareholders. The aim of a flip-in plan is to dilute the shares of the bidder company and make the takeover less attractive. A flip-over plan allows the shareholders to purchase the shares in the bidder company at a discount in the event of a merger, which dilute the equity of existing shareholders in the bidder company.

Golden parachute

A golden parachute can be treated as a compensation for the management of a target company. This tactic guarantees that the incumbent management will gain a lump-sum payment of cash if a company is taken over and they are fired or their jobs are eliminated (Hantly, 1992). This tactic becomes effective when a possible bidder company purchases a particular percentage of ownership in the company. Besides, it can be annulled in the case of a friendly takeover (Weston, 2001).

On the one hand, this tactic can guarantee the wealth of the management team of the target company. On the other hand, it can increase the cost for a bidder company to take over. It aims to keep key employees who feel threatened by a possible takeover. Based on Knoeber (1986), the golden parachutes is to combine the motivations between the shareholders and the management team of the target company. He also discovers a positive relationship between profitability of anti-takeover and golden parachute. The profitability of success that a target company resists a takeover depends on how much money the management team can get. However, implementing golden parachute is extreme high and reaches to million dollars. Therefore, a high compensation for the incumbent management team of the target company can reduce the chance of being takeover (Hanly, 1992).

The company can announce a golden compensation before a takeover. This tactic can be written in the articles of association of a company. Besides, the extent of a golden parachute may cover more than the top management of the company, such as the middle managers, employees etc. In addition, the total amount of a golden parachute can be larger than the annual compensation of an incumbent management, because such compensation makes a company more expensive to purchase (Choi, 2004).

Staggered boards of directors

According to Pearce and Robinson (1994), only a certain number of board members (usually one third of them) can be elected in a given year under a staggered board agreement. A successful hostile takeover depends on whether a bidder company is able to gain the control of a target company's board of directors. Normally, the bidder company elects new directors to replace the incumbent directors who are against this takeover bid. The aim of this tactic is that anyone taking control of the company must wait a few years before they fill the board with new members.

This defense is widely used in western countries. A staggered board of directors is a prominent tactic in US corporate law. The board of directors of a company is divided into several classes, such as Class I, Class II, etc. Therefore, it also is called as classified board. More than 70% of US companies stagger their board of directors.

Supermajority provisions

Supermajority provisions require shareholders approval by at least 80% of votes for all transactions involving change of control, a merger, a takeover, etc. This defense tactic limits the ability of the bidder to take possession of the target company even if he/ she have managed to bring the board of directors under his/her control. If a bidder company wants to obtain control of the target company, it requires a higher percentage of shares, and this tactic increases the cost and difficulty of takeovers (Ruback,1987).

2.6.2 Reaction defense tactics

Litigation

Litigation means that a target company can sue a bidder company during a hostile takeover process, due to the behavior of the bidder company breaks the related policies, regulations (Weston, 2004). According to Pearce and Robinson (2004), litigation includes a legal injunction and a restraining order against a pursuer. When the pursuer is preparing a legal rebuttal, the target company can strive for extra time and others tactics to repel this hostile takeover. The value of the litigation is to extend the negotiation period and provide more space of response from the target company (Rose, 2005). According to Chinese anti-monopoly law, there are three charges that a target company can use to repel a bidder company. The first charge is whether this takeover violates Chinese anti-monopoly laws. The second charge is an inadequate disclosure that a bidder company has not fully disclosed all available information. The third charge is fraud that one party deliberately misrepresents which causes another party to suffer damages, even monetary losses. However, a fraud charge is rarely used because it is not easy to prove.

Besides, Ruback (1987) insists that litigation can be categorized as a administrative resource. The target company deploys this tactic as a shield to repel a hostile takeover from the bidder company. He also believes in the positive effects of litigation on preventing hostile takeover.

White knight

According to Shleifer and Vishny (1985), a white knight may be a corporation or a person that intends to help a target. The target company can provide a buy invitation to others. During a hostile takeover process, the board in the target company decides to seek for a company that has better takeover conditions. Therefore, companies that can rescue a target company from a hostile bidder are called “white knights”. The intention of them is to rescue the target company from a hostile takeover and defeat the bidder company by offering a higher bid.

Carolyn and Griffith (1998) also indicate the reasons that a target company is willing to be purchased by another friendly company. A target company believes a better compatibility between two companies, when the target is purchased by a white knight, and they create a win-win situation. Meanwhile, the white knight usually promises not to break up the target company and sell it piece by piece and the board and management are promised positions in the new combined company. However, Mayer and Jenkinson (1994) also present the risk of the white knight. It has capability to become a potential bidder company, because it is easy to access the confidential information and documents of the target company.

Greenmail

Pearce and Robinson (2004) claim that Greenmail can be used as a reaction defense to prevent hostile takeovers. The greenmail is to repurchase shares that have been purchased by a company or a person. In practice, greenmail is buying back shares at a higher market price in order to block a hostile takeover. Therefore, a greenmail is also called the target repurchase. Shares are repurchased by the target at a higher price which makes the bidder happy to leave the target alone (Shleifer and Vishny, 1986). The intention of a greenmail is to end a hostile takeover threat. However, Pearce and Robinson (2004) also indicate that the greenmail hurts the interests of the shareholders of a target company, because the Tax Reform Act of 1986 stipulates that companies have to pay 25% tax as a penalty when they are implementing a greenmail as a defense tactic.

Macey (1986) states that this tactic cannot be used alone, because it may attract other bidder companies when they see the possibility to get a profit on the premium that is paid by the target company. Therefore, it is easy to lose its effect and it may let other bidder companies to launch new takeovers again. The most effective way is to combine with standstill agreement which implies that the bidder company agrees to not purchase any shares for a certain time period (Gaughan, 1996).

Share buyback

Unlike the greenmail, this type of share buyback means that a target company buys out its own shares from the market in order to reduce the number of its shares on the market, it also can increase the ownership in a company (Gordon and Kornhauser , 1986). According to Sinha (1991), this tactic increases earnings per share and raises the market value of the remaining shares. Pearce and Robinson (2004) present that share buyback as capital restructuring effect in the target company. However, the target company carries out share buyback based on two conditions: enough cash and low debt. This tactic is quite expensive than other tactics and the optimal level of this tactic is to trade-off between the benefit of takeover defending and the risk of bankruptcy.

Standstill agreement

According to Pearce and Robinson (2004), standstill agreement is a contract that restricts behaviors of a target company and a bidder company. This tactic includes a clause that does not allow the bidder company to acquire any stocks from the target company for a specific time period. In order to exchange with the bidder company, the target company has to pay an amount of fee for the bidder company. Ruback (1987) indicates that this agreement limits ownership of the target company for a specified time period, such as voting right, etc. Dann and Angelo (1982) argue that the standstill agreement is a voluntary contract and gives the rights of the target company to keep shares. Meanwhile, in order to honor this agreement, the target company is not allowed to sell any shares to a third party.

Scorched-earth

Scorched-earth is a popular defense tactic that has been applied in most EU countries. This tactic derives from the traditional war technique of starving an invading army by razing the countryside. When a target company is facing a hostile takeover, it can sell all the assets or even destroy them. This tactic can be treated as the extreme of poison pills which is taking place after a takeover bid. The primary aim of this tactic is to make the target company less attractive when a hostile takeover is in action. However, Hirshleifer (1991) points out the potential risk of scorched-earth. If the most valuable assets of the target company are sold, the value of shareholders will be reduced and the competitive advantage will be decreased, even influences the future development of the target company.

Crown jewel

To fight back a hostile takeover, the target company can sell some of the most valuable assets, which is called a crown jewel, even sell these assets to a third party to reduce the value of the company and force the bidder company to draw back the bid. The most valuable assets represent the largest reason that companies become takeover targets. Under this situation, the company should make it seem as ugly, poor and worthless as possible rather than making the company beautiful with high value.
This tactic can be used as asset protection (Mayer and Jenkinson, 1994). According to Gilson and Brnard (1995), the target company can sell the crown jewel to a white knight.

White squire

A white squire is a modified version of the white knight. The white squire just acts as an allied friend and buys a large number of shares from the target company. The white squire uses these shares to vote against the hostile bid. The difference between a white squire and a white knight is that a white squire does not take control of the whole company as in a white knight strategy. In order to return the generous help of a white squire, the target company always provides generous dividends, or a seat on the board of the target company (Weston et al, 2004).

Pac -man

The Pac-man defense tactic is named from a video game. The objective of this game is to eat the attacker to avoid being eaten by the attacker. Using this defense tactic, the target company can purchase the bidder company that has placed the hostile takeover bid, either in the market or through a good offer. If the target company purchases enough shares of the bidder company, it might be able to gain a position in the board of directors of the bidder company, even a vote right (Weston et al, 2004). Weston and Mitchell (2006)) point out that this defense is extremely costly and has devastating financial effects for both companies. In order to afford to buy the shares, both companies have to use debt to afford these shares and lead them to a huge debt stake.

3. Methodology

Aim of this chapter is to present and motivate our choice of research method. We will discuss the difference between a qualitative and a quantitative method. Then we will illustrate the choice of research method, and the process of data collection. The case study will also be accounted for this chapter. This chapter is concluded with an account for the validity and reliability of research method.

3.1 Research method

According to Coop and Schindler (2003), a research method refers to an entire process of solving or answering research problems or achieving research objectives. It includes two types of methods: qualitative and quantitative methods. A qualitative method stresses on understanding a human behavior or reasons of this behavior. The information of a qualitative method relies on general conclusions from a case study (David, 1997and Babbie, 2010). A quantitative method indicates the empirical investigation of a phenomena and a relationship, which can be used to test and verify a hypothesis. The objective of quantitative methods is to use theories, mathematical models and hypotheses to explain the phenomena and the relationship unlike the quantitative method, the qualitative method is less rigid based on the data collection process (Babbie, 2010).

The aim of this thesis is to find the suitable defense tactics for Fangxin to prevent a hostile takeover. Since we do not use any number or statistics in Fangxin's case, a qualitative method is suitable in this thesis.

3.2 The case study

We choose to conduct a case study with several reasons. First, Fangxin is facing the hostile takeover problem, and we are trying to solve this problem in this thesis. Second, it is interesting to conduct the existing theory in hostile takeovers on an unlisted company. Third, the case study stresses detailed analysis of the Fangxin and its condition, and helps us to examine a real-life situation or problem.

3.3 Data collection

There are two types of data can be used when conducting research: primary and secondary data. Primary data is raw data which is collected by an author with a specific intent. Common ways to collect the primary data consist of surveys, interviews, questionnaires, etc. (Babbie, 2010). Primary data have the following advantages. First, they focus on the specific issues. Second, they control what the researchers have. Third, they represent a larger population. These data allow the researcher to determine the type of method and how long they can get the data. Whereas a negative side is that they can be seen as a costly and time-consuming process (Roos et al., 1987).

The second type of data is secondary data, which is collected by other researchers or can be found through books, articles, newspaper or internet etc. Secondary data cover main advantages such as saving time and money, serving a basis of comparison of other data etc. (Babbie, 2010). The major disadvantage is that the researcher cannot check the reliability of data. A difference between the primary and secondary data is that secondary data are collected for other researchers with other purposes (Saunders and Thornhill, 2003).

In this thesis, the data will be secondary data since the used data is gathered for other purposes. We choose secondary data for two reasons. One of reasons is that secondary data save a lot of time and reduces costs. Other reason is that this thesis analyzes and selects previous defense tactics to fulfill the purpose of this thesis, and therefore secondary data is more suitable in this thesis.

3.4 Reliability and Validity

Hernon and Schwartz (2009) indicate that reliability is a repeatability of a measurement, which refers to those same results, can be produced by different samples of the same population. Validity actually measures what it actual measures (Kirk and Miller, 1986).

We have to discuss and assess the reliability and the validity of the data collected when we are using secondary data. According to McCloughan, 2001, the best procedure is to make comparisons between data and the reputable sources, such as science texts, other references and information from reputable site on the internet. The data in this thesis is collected from public information and large organizations such as scholar Google, University Twente's database, the PRC Company Law, the Administration of the Takeover of Listed Companies and the China Securities Regulatory Commission (CSRC), and is believed to be very trustworthy and give the thesis validity and reliability. Besides, the theories used in this thesis are well-known and trustworthy literature, which increases the reliability for this thesis.

4. Analysis

In this chapter, we analyze the feasibility of the defense tactics under Chinese law. We will tie the literature review (2.6) together with the case study. We will eliminate some defense tactics that are not suited and concentrate on the suitable ones. Among the suitable ones, we will analyze them impact on the takeover process.

4.1. Prevention defense tactics

Prevention defense tactics can be applied before the threats of takeovers. They can create legal and economic barriers to prevent the control of the bidder company and can be treated as proactive steps that are taken by the target company to reduce attractive as a target.

Poison pills

As we mentioned before, poison pills have two types: flip-in and flip-over rights. The advantage of flip-over right for a target company is to dilute the ownership position of current shareholders of a bidder company. The advantage of flip-in right for a target company is to dilute the target stock regardless of amount purchased by a potential bidder company. Making a target company less attractive to white knights is the major disadvantage for a target company.

According to Article 33 of the Administration of the Takeover of Companies Procedures (the Takeover Measure), this article indicates that supervisor and senior management may not hurt the legal rights and interests of the target company and its shareholders. Moreover, Article 33 specifically prohibits the following types of defense actions when the target company’s board of directors decide to repel a hostile takeover: issuing shares and convertible bonds, repurchasing shares, amending the target company’s articles of association, entering into contracts that have a material effect on the target company’s assets, liabilities, interests or results of operations, disposing or purchasing major assets or changing the target company’s principal business.

As mentioned in literature review part, poison pills are rights issued to the shareholders of a company in addition to their shares. This tactic issue shares to its shareholders which violates the Article 33.therfore.Till now, none of companies in China have used poison pills as a defense tactic to repel hostile takeovers. It is a forbidden defense tactic under the Chinese law, because it hurts the interest of the shareholders, destroys the perspective, and worsen the current situation of the target company etc.

Golden parachute

As mentioned in the theory, golden parachute provides a lump-sum payment of case to the management of a company if a company is taken over and they are fired or their jobs are eliminated. It has some advantages as follow, guaranteeing the wealth of the management of the target company, motivating the management to protect the target company, increasing the cost of a hostile takeover and tending to reduce it likelihood. However, the obvious disadvantage is that the management might engage in an opportunistic behavior. They may use a hostile takeover bid as an advantageous tool in order to get large money as payments. Besides, this tactic only covers the top management of a company.

According to the Chinese Labor Law, there is no regulation about the staff and treatment of a company after a merger. When the company implements the golden parachute as a defense tactic, it leads to several problems, such as carving up company-owned property even state-owned property. It does not motivate the management of the company. However, the Chinese Labor Law does not stipulate explicitly that a golden parachute is a forbidden defense tactic. Based on the Article of 38 of the PRC Company Law, shareholders' meeting has the power to decide the payment of board of directors. Therefore, this tactic is located in a grey area in the

Chinese law.

Under the Chinese law it is possible to use this tactic. The first “golden parachute” in China was used by Aishi Limited Liability Company to repel a hostile takeover by Dagang Limited Liability Company in 1998. In this case, Aishi announced a “golden parachute”. If one company takes over Aishi, it must pay RMB 136,000 to every member of the board of directors of Aishi in one time and put the incumbent management in a proper place. This tactic increased the cost of takeover. Ultimately, Dagang gave up this takeover.

Staggered boards of directors

Staggered boards of directors indicate that only a certain number of board members (usually one third of them) can be selected in a given year under a staggered board agreement. A success of a hostile takeover depends on if a bidder company is able to gain the control of a target company’s board of directors. Normally, the bidder company elects new directors to replace the incumbent directors who are against this takeover bid. One of its advantages is to delay the bidder company’s ability to gain the control of the board. However, the main disadvantage is to increase the size of the board.

The PRC Company Law sets out the basic requirements based on the structure of a PRC company’s board of directors. Article 46 of the PRC Company Law regulates that a director may serve for a term of up to three years. Article 96 of the Takeover Measure, a director’s term starts from the date on which he or she takes office and ends on the date on which the term of the current board of directors expires. However, the PRC Company Law keeps silence as to whether a director of the board can be staggered.

In recent years, there are many examples of a “staggered boards of directors” defense tactic. For instance, the articles of association of Aishi LLC, it stipulates some conditions to enter the board of directors: only 3 member of the board of director (there are 13 shareholders) can be elected in two years, the share percentage must be over 10% and be held for at least one year. According to this article, even one company holds more than 10% of shared, it still a big shareholder without management right.

Supermajority provisions

Supermajority provisions indicate that major change must be approved by majority of shareholders in the general shareholder meeting. This tactics increases the difficulty to transfer the right of control of one company, helps to prevent hostile takeovers which hurt the interest of shareholders and the company. Besides, it is beneficial to consolidate management control for the company. Meanwhile, this tactic restricts the power of controlling shareholders to control the company.

Article 104 of PRC Company Law stipulates that amending the charter, approving a new version of the charter, raising or reducing registered capital, reorganizing or liquidating the company must be taken by more than two-thirds of the votes in shareholder meeting. Furthermore, Article 105 of PRC Company Law stipulates such decisions as transferring of a company, dealing with major property, offering for security and others must be approved by a general shareholder meeting. Besides, this Article indicates that supermajority provisions must be written in the articles of association of one company. Therefore, this is a legal defense tactic under Chinese law. Nowadays, more and more companies apply supermajority provisions in the articles of association.

Table 3 Summary of prevention defense tactics

Types of defense tactics	Advantages for a target company	Disadvantages for a target company	Impact for a target company	Shareholders' approval	Feasibility in China
Poison pill	Dilutes ownership position of current shareholders of a bidder company (flip-over). Dilutes target stock regardless of amount purchased by a potential bidder company.	Makes less attractive to white knight Cannot be approved by some countries	Make a hostile takeover more expensive. Increase the cost of hostile takeover.	Not required.	It is a forbidden defense tactic.
Golden parachute	Guarantees the wealth of the management of a target company, motivates the management to protect the target company.	Only cover the top management	Raise the bidder's cost.	Required.	Can be used.
Staggered boards of directors	Delays a bidder company's ability to gain the control of the board.	Increases size of board.	Bidder cannot get control of target company after obtaining a majority of shares.	Required.	Can be used.
Supermajority provisions	Increases the difficulty to transfer the right of control of one company, consolidate management control for the company.	Restrict the power of controlling shareholders to control the company.	Limit the ability of the bidder to take possession of the target company.	Required.	Can be used.

4.2 Reaction defense tactics

In this sub section, we will analyze reaction defense tactics under the PRC Law.

Greenmail

A greenmail is a practice of buying back the target company's stock from a company who acquires a large block of the target company's stocks. The price of share repurchase is much higher than the market price. The purpose of this tactic is to reduce stock in the open market and decrease the chance of being takeover because the bidder company cannot obtain enough stock to control the target company. This tactic has some advantages and disadvantages. The advantage is that the target company bribes the external bidder and encourages it to go away. However, this tactic also increases the negative public image for the target company and hurts the interest of the shareholders of the target company. So greenmail cannot be used alone. It can combine with a standstill agreement to eliminate the hurt of the interest of the shareholders of the target company.

Nevertheless, Article 149 of the PRC Company Law restricts share repurchase. Based on the new version of Article 143 of the PRC Company Law in 2005, the target company can repurchase its own shares in order to reward to the company staff. However, the repurchase share should be less than 5% of the issued stock. Besides, Article 62 of the Administration of the Takeover of Companies Procedures stipulates one condition to implement the greenmail. First, the target company cuts the equal value of assets to repurchase own shares. For instance, one company decides to repurchase shares which worth RMB 500,000, it has to sell its asset which also worth RMB 500,000. Besides, the PRC Company Law stipulates that a company has to destroy the repurchase shares as soon as possible.

Moreover, the PRC Company Law also stipulates that a company has to report the share repurchase to the China Securities Regulatory Commission (CSRC), this complicated procedure delays the timeliness of this tactic. Although greenmail is a legal defense tactic, it does not work in operation. Up to the present, none of companies uses this tactic in practice.

Share buyback

Share buyback means that a target company buys out its own shares from the market. On the one hand, the share buyback can increase share price and market capitalization. On the other hand, it can reduce the attraction and eliminate the financial control from a bidder company.

In the past, the PRC Company Law restricted that a company repurchased its shares from the market. According to the new version of Article 143 of the PRC Company Law, it relaxed the former restriction about share repurchase. It stipulates that a company can repurchase its own shares under two conditions. One is to reduce the company's asset and the other is to merge with other companies who hold shares of the company. Moreover, the PRC Company Law only emphasizes that a company cannot hold the repurchased shares in its hand and has to cancel these shares within ten days (count on the date that a company had repurchased). Share buyback is not a forbidden tactic under the Chinese law. Whereas, related legal regulations and complex procedures delay the effectiveness of this tactic. It is hard to implement in practice, we cannot find a Chinese company which uses this tactic.

Standstill agreement

A standstill agreement includes a clause that a bidder company cannot purchase any stocks from a target company for a specific time period. In order to exchange with the bidder company, the target company has to pay an amount of fee[16] for the bidder company. This tactic reduces the chance of being takeover and prevents the bidder company for a specific time period. However, this tactic increase amount of fee to get the bidder company to sign this agreement and only provides temporary reprieve. Usually, this tactic combines with greenmail, which implies that the bought out stockholders agree to not buy any new shares in the company for a time period. Besides, the PRC Company Law approves that standstill agreement is a legal tactic. It ties up greenmail, which increases the difficulty level to implement this tactic.

16. Fee indicates that how much money a target company is willing to pay for a bidder company. After getting this fee, the bidder company cannot access any shares of the target company.

Litigation

Litigation is a common defense tactic that is used by target companies. Litigation means that a target company can sue a bidder company during a hostile takeover process, due to the illegal behaviors of a bidder company. Usually, some behaviors of the bidder company violate the related policies and regulations. The positive effects of litigation as delays in the issue of rulings, stretches out of court proceedings, afford the target company the time to set up defense tactics. The advantages of this tactic are mentioned above. However, this tactic turns out to be very expensive.

The PRC Company Law and the Takeover Measure indicate that the following three conditions will lead to a charge. First, takeover procedures go against antitrust law. Second, takeover behaviors violate the takeover procedure and the securities law, such as public announcement, information disclosure. Third, the purpose of a bidder company is to manipulate the market or greenmail, but not to gain the control of a target company. If the target company finds out that the bidder company's behavior actually fits one of three conditions, the target company can take a legal action and put on record with relevant evidence to local law department. The bidder company cannot continue this takeover before the result of judicial decision. Therefore, this tactic can be used in China. s

There are many examples of "litigation" tactic used in China. In Sep, 1993, Shenzheng Baoan betrayed confidential matter and announced the internal information of Yanzhong Shiye in public, which violated the second condition (as mentioned above). Therefore, Yanzhong Shiye started a suit to Shenzheng Baoan's illegal behavior.

White knight

White knight can be described that the target company seeks for a friendly acquirer to prevent being bought by the hostile bidder. Therefore, companies that can rescue the target from hostile bidder are called white knights. When the target company faces a hostile takeover, it can find a third party to compete with the bidder company. Under this situation, the bidder company either increases the tender offer, or gives up the takeover.

On the bright side, the white knight may be preferable to the hostile bidder and raise the bid value. Meanwhile, it also brings some disadvantages for the target company. Such as the target company loses its independence, the white knight has a chance to be a potential bidder, because the white knight can access the private information of the target company. Besides, in order to attract the white knight, the target company has to give some risk compensation. In the Chinese securities law, the white knight can be used in Chinese market. However, there is no clear regulation for the risk compensation between the white knight and the target company. The Chinese securities law states that the management of the target company can repel hostile takeover for self-protection.

Therefore, white knight can be applied under the Chinese law. Some cases also adopt "white knight" as a defense tactic in China. In 1999, Shangdong Shengbang made a "white knight" role to rescue Shenli Corporation (the target company) from a hostile takeover. Huitong Corporation purchased 13.77% of shares of Shenli. Meanwhile, Shenli involved in some economic disputes and could not stop this takeover. Therefore, Shenli invited Shandong Shengbang to repel this takeover.

Scorched earth

This tactic indicates that the target company sells all the valuable assets or even destroys them. The advantage of this tactic is to make the target company less attractive for the bidder company. The valuable assets can be a subsidiary company, a department, an asset, an Intellectual property, even experts etc. these valuable asset are the real purposes behind hostile takeovers. Sometimes, the target company sells the valuable asset at low price, purchase harmful assets, increase liability. However, this tactic can bring some risks. When the most valuable assets in the target company are sold out, the total value of the target company will be reduced and the competitive advantage will be eliminated, even influences the future development of the target company.

According to Article 33 of the Takeover Measure, target companies can not dispose of or purchase major assets during hostile takeovers. However, this tactic totally violates the Article 33 and can be seen as a forbidden defense tactic in China.

Crown jewel

Crown jewel refers to as the most valuable assets of the target company. When companies face takeover threats, they can sell these valuable assets to eliminate the values. There are few advantages and disadvantages of the crown jewel. The main disadvantage indicates that the company becomes less attractive not only for the bidder company, but also for the existing shareholders of the company when the most valuable assets of the company are sold out. The advantage of this tactic is to make the target company less attractive for the bidder company.

However, under China law it is impossible to use this tactic. Article 33 of the Takeover Measure stipulates that the following item is prohibited: purchase or disposing of key assets. This tactic disposes the most valuable asset during a hostile takeover which goes against the regulation of Article 33. Under China law, crown jewel can be seen as a forbidden defense tactic in China.

White squire

Based on the Takeover Measure and the PRC Company Law, they do not restrict or forbid this tactic. Therefore, we can confirm that this tactic is legal defense tactic under the Chinese law. There are many examples of a “white squire” defense tactic in China. For instance, Baihui LLC has purchased the 13.77% of shares of Shengli LLC from its fourth majority shareholder. When Shengli LLC was facing the threat of takeover from Baihui LLC, Lianbang LLC acted as a white squire and purchased 27.35% of shares of Shengli LLC in order to keep the control from the management of Shengli LLC.

I***Pac-man***

Till now, the Chinese law does not have any restrictions about the pac-man tactic. Therefore, this tactic can be used under the Chinese law. There are many examples to use this tactic. For instance, Jiuyang Company purchased 30% of shares of Meide Company with RMB 10.48 per share. After one month, Meide Company also purchased 42% of shares of Jiuyang Company. Due to the increasing cost of both companies, they stop this battle finally.

Table 4 Summary of reaction defense tactics

Types of defense tactics	Advantages for a target company	Disadvantages for a target company	Impact for a target company	Shareholders' approval	Feasibility in China
Greenmail	Encourages the bidder company to go away.	Negative public image Generates litigations Lose money on a takeover attempt.	Eliminates a potential bidder.	Required.	It is hard to use in China.
Share repurchase	Reduces number of shares from the open market. A bidder is not easy to purchase the target shares.	Some countries limit ability to repurchase own stock from the open market.	Eliminates a potential bidder.	Required.	It is hard to use in China.
Standstill agreement	Prevents a bidder for a specific time period.	Provides a temporary period. Pays amount of money to potential bidder.	Delays a potential bidder temporarily.	Required.	It is hard to use in China.
Litigation	Strives for time for a target to build defense tactics.	Negative impact on target shareholders' return.	Delays a hostile bidder.	Required.	Can be used.

White knight	Prevents being bought by the hostile bidder.	Loses the target's independence.	Rescue by a friendly bidder.	Required.	Can be used.
Scorched earth	Being less attractive for the bidder company. Makes the company seem as ugly, poor and worthless as possible.	Be expensive and risky Decreases shareholders' value.	Makes the target less valuable.	Required.	It is a forbidden tactic.
Crown jewel	Being less attractive for the bidder company. Makes the company seem as ugly, poor and worthless as possible.	Decrease shareholders' value.	Makes the target less valuable.	Required.	It is a forbidden tactic.
White squire	Prevents being bought by the hostile takeover.	White squire betrays the target company.	Rescues by a friendly third party.	Required.	Can be used.
Pac-man	Eats the bidder company to avoid being eaten itself. Does not take over the target company.	Expensive.	Making of a counterbid to buy the shares of the bidder company	Required.	Can be used.

4.3Defense tactics for Fangxin

This section will discuss defense tactics that can be applied by Fangxin in this takeover.

Litigation

In this case, Fangxin can adopt this tactic to protect itself. According to the Takeover Management Rules in 2006, the tender offer is a public and open and it should be announced in a newspaper by the bidder company. However, only the shareholders of Fangxin received takeover bid from Maker, none of local newspapers announced this bid. It is obvious that Maker does not take the compulsory obligation. Therefore, Fangxin can sue Maker because Maker did not follow the obligation of a tender offer. When Maker receives this summons, it will prepare a legal rebuttal. The aim of litigation is to extend the negotiation period between Fangxin and Maker and provides more spaces to respond this takeover. Meanwhile, Fangxin can strive for time and figure out the effective defense tactic against this hostile takeover.

White knight

When Fangxin adopts this tactic, it has to find out a friendly third party. According to the understanding of Fangxin, Ketai bioengineering company can be considered as a friendly third party. Ketai is chosen for the following reasons. First, Ketai bioengineering company had set up a long-term cooperation with Fangxin since 2005. Ketai became the major sale representative, which sold and popularized Fangxin' two-in-one drugs testing reagent in Beijing and neighboring provinces, such as Hebei, Tianjin, Shandong etc. It helped Fangxin to explore the market of Beijing and neighboring provinces. Besides, the experts of Fangxin also provided technological guidance to Ketai. Meanwhile, Ketai also hosts meetings to exchange technical knowledge twice a year. These meetings aim to reinforce technology training among the staff in Ketai, and it invites the skill experts to host a workshop for Ketai's technicians.

Second, an important reason that chooses Ketai as the third party is "Guanxi". According to Park and Luo (2001), Guanxi originates in the Chinese society that describes the personal networks of influence. It also refers to the benefits gained from the social connections from friends, workmates, family and members of organizations. Xin and Pearce (1996) also states that Guanxi exists everywhere in the Chinese society. The cooperation between Fangxin and Ketai involves in Guanxi. The CEO of Ketai is the cousin of the CEO of Fangxin. Due to this family relationship, Ketai becomes the suitable third party to rescue Fangxin from this takeover.

Based on above reasons, Ketai can act as a white knight. Ketai can give an offer on Fangxin which the board of Fangxin considers as a option. Then Fangxin's shareholders vote to accept Ketai as an acquisition of the company and the hostile takeover attempt from Maker is over. Meanwhile, in order to ensure that Ketai is not a potential bidder, Fangxin can sign a formal contract with Ketai before the cooperation. This contract involves that Ketai promises not to break up the target company and sells Fangxin piece by piece, and the board and the management of Fangxin are promised suitable positions in the new combined company.

White squire

In this case, Fangxin can look for a white squire as an alien fried in a hostile takeover process. The white squire can purchase large block of shares in Fangxin (even becomes a majority shareholders in the target company). The white squire uses these shares to vote against the hostile bid and can together with the board of Fangxin prevent the hostile takeover. Besides, these shares which have purchased by the white squire can be tailored with restrictions that unable to sale to a third party. Therefore, shares of the white squire are not easy to be purchased by the bidder company and it can reduce the chance that a bidder company takes over the target company. In this case, Ketai can act as a white squire and purchases a large number of shares from Fangxin. Meanwhile, In order to reward the generous help of Ketai, Fangxin can provide the generous dividends, or a seat on the board of Fangxin.

Pac-man

Fangxin can also adopt this tactic. Fangxin can copy Maker's way to provide a tender offer to the board of directors of Maker and even purchase the shares from one of the shareholders of Maker in order to gain a position in the board of director of Maker. As mentioned before, Maker enhanced the hostile bid to RMB 29.7 million. Fangxin can announce a bid in the same way as Maker. However, this defense tactic is hard to implement under most cases and is suited for targets companies that are larger than the bidder companies. In order to implement this defense tactic, Fangxin has to investigate the basic background of Maker such as total asset, profit, debt, etc. if Maker is larger than Fangxin, this tactic is not suited for Fangxin anymore.

4.4 Combination of defense tactics

After analyzing the feasibility of defense tactics under the Chinese law, only four reaction defense tactics can be applied in Fangxin: litigation, white knight, white squire and pac-man. These defense tactics are preferably implemented in combination of each other. They are used in combination with each other to ensure the effectiveness of the defense. However, we cannot guarantee a withdrawal of the hostile bid offered, only provide the possible combinations.

Combination of defense tactics
Litigation + White knight/ White squire
Litigation + Pac-man

Table 3 Combination of defense tactics

The first combination comprises litigation and white knight/White squire. Litigation can be used as a shield to delay hostile attacks for a target company. According to obligation of tender offer in China, a bidder company should announce a tender offer in public and newspapers. However, Maker only offered a tender offer to Fangxin, none of local newspapers announced this offer. Hereby, Maker violated the requirements of tender offer, Fangxin can bring an action against Maker in local court. When Maker receives a summons and prepares a legal rebuttal. During the preparation period of Maker, Fangxin can strive for time and look for a white knight/white squire. Based on the several business partners, Ketai can be a suitable white knight/white squire for Fangxin. When Ketai acts as a white knight, it will take control of Fangxin. When Ketai acts as a white squire, it only purchase large block of shares, becomes one of majority shareholders and takes a place in the board of directors in Fangxin. Meanwhile, Fangxin still keeps its autonomy.

The second combination includes litigation and pac-man. Maker did announce the bid offer in public which violated requirements of tender offer. Therefore, Fangxin can take legal proceedings against Maker. When Maker is preparing a legal rebuttal, Fangxin can imitate Make's way to offer a tender offer to the board of directors of Maker, purchases a large number of shares and becomes one of shareholders of Maker.

4.5Missing defense tactics

There are several defense tactics that are described and analyzed in section 4.1, but are not used in any of them in this case studies. We will give the reasons why they are not used as follow.

Prevention defense tactics

Although some of prevention tactics can be used under Chinese law. However, this type of defense tactics is used before the threat of a hostile takeover. These tactics also can be used as proactive steps to avoid being a target. As mentioned in section1.2, Fangxin had already received a hostile bid from Maker. Therefore, these tactics cannot be applied in this case.

Reaction defense tactics

Article 33 of the Takeover Measure stipulates that a target company cannot dispose or purchase major asset after a bidder has publicly announced its intention to take over the target company. Crown jewel and scorched-earth defense tactics sell or destroy the most valuable asset of a company, which go against the Article 33. As a result, they are forbidden tactics under Chinese law.

Based on new version of Article 143 of the PRC Company Law, it relaxed the former restriction of share repurchase. A target company can repurchase its shares from open market or someone who hold a large block of the target company's stocks. Moreover, it also stipulates that a company has to cancel the repurchase shares within ten days. In order to implement this tactic, the target company has to report to CSRC, the complicate procedure delays the timeliness of share repurchases. Although, greenmail and share buyback are legal defense tactics, they are hard to use in practice. Up to now, none of companies uses these two defense tactics in China.

Although, the PRC Company does not prohibit the widespread use of standstill agreement, it usually combines with greenmail. As mentioned above, it is not easy to implement greenmail in practice. Based on same argument, standstill agreement is not easy to use in practice.

5. Conclusion

We present a conclusion in this final chapter. The aim of this chapter is to fulfill the purpose of this thesis. It also contains a recommendation for future development of Fangxin.

5.1 Research conclusion

Despite the financial crisis in recent years, there are an increasing number of hostile takeovers taking place in China. Hereby, ability to protect itself or prevent hostile takeover seems to be a relevant study for most companies with valuable assets in China.

Therefore, the research question of this thesis is “How can Fangxin Biotechnology Company protect itself from a hostile takeover?”This question was divided into three sub questions. First, we examined the motivations behind this hostile takeover. Based on these motivations, we could find a better way to repel this hostile takeover. The second question was to find out the common defense tactics against hostile takeovers which are discussed in literature. The last question was to describe which of defense tactics or different combinations were effective to repel the hostile takeover in this study. Based on these questions, we stated the purpose of this thesis:

“*To find out the suitable defense tactics which enables Fangxin fight back the hostile takeover.*”

In order to answer the research problem and achieved the research objective, we conducted a qualitative research method. A qualitative method stresses on understanding a human behavior or reasons of this behavior. The information of a qualitative method relies on general conclusions from a case study. Therefore, Fangxin was selected as the case study of this thesis. In this thesis, we used secondary data, which can be found in books, articles, online etc. one reason behind choose secondary data is that saves a lot of time and reduces costs. Meanwhile, it broadens the research topic than otherwise possible.

During the analysis of different defense tactics, we find that companies can use various defense tactics to protect themselves or increasing the bids. Due to the different legal systems and regulations, it is hard to find a tactic that is universal and be suitable for all companies. Based on the current situation of Fangxin, all the prevention defense tactics cannot be used in this case. Therefore, there are only two defense tactics that Fangxin can adopt in practice: litigation and white knight.

Because Maker did not follow the compulsory obligation of tender offer, Fangxin can submits such case to the local court and starts a suit in a law court. One the one hand, this tactic helps Fangxin to extend the negotiation period with Maker. On the other hand, Fangxin can strive for time and figure out the effective defense tactic against this takeover. Besides, Fangxin can find a friendly third party to rescue itself from this takeover. As mentioned above, Ketai can take a “white knight” role, Fangxin either can be bought by Ketai or Ketai can outbid Maker at for the tender offer. So Fangxin can apply either litigation or white knight to go against this takeover.

Fangxin can apply pac-man and white squire defense tactics to fight back this hostile takeover. Implementing pac-man tactic, Fangxin can purchase the share of Maker from its shareholders in order to gain a position in the board of director of Maker; even provide a tender offer to the board of directors of Maker. However, this tactic is extremely expensive, and it easy to cause plenty of debt financing for both companies. Fangxin can also use the white squire defense tactic. In this tactic, Ketai can play the role of white squire and purchase a large number of shares of Fangxin In order to reward the generous help, Fangxin can provide the generous dividends, or a seat on the board of Fangxin.

In order to increase the effectiveness of these defense tactics, we provide possible combination of defense tactics: litigation and white knight/ white squire and litigation and pac-man. However, we just provide the possible combination and cannot guarantee a withdrawal of the hostile bid.

a) Recommendations

Regarding to this hostile takeover, Fangxin has to adopt some defense tactics to resist future takeovers, which are applied before real takeovers. As mentioned in literature review part (section 2.6), we introduced three types of prevention defense tactics: golden parachute, poison pills and stagger board of directors These tactics can be applied before the threat of takeovers and can be used as legal or economic barriers to resist hostile takeovers and even block the control of the bidder company. However, the PRC Company Law states that poison pill is a forbidden tactic. Only golden parachute and stagger board of directors can be applied under Chinese law.

Based on the characteristic of Fangxin, golden parachute can be used as a prevention tactic. The main objective of golden parachute is to help the executives to resist takeover takeovers and enhance the takeover cost for the bidder company. Golden parachute is lump-sum payments of cash that compensate the executives in case of loss of their jobs. In addition, golden parachute can cover more than the executives of the target company, such as middle managers, employees etc. Hence, Fangxin can announce an amount of cash to the incumbent management team before future hostile takeovers. Therefore, Fangxin can add golden parachute in its articles of association.

Fangxin also can adopt “stagger boards of directors” tactic, this tactic aims to delay a bidder company’s ability to gain the control of the board of the target company. Therefore, Fangxin can stipulate that exactly number of the board of directors can be elected in a given year after shareholders’ meeting. Such as, two or three numbers of the board of directors can be elected in one year. The lengthy of election and replacement delay a significant deterrence for potential bidder who needs to obtain the control of the target company immediately.

b) Limitations

There are several limitations regarding this thesis. First of all, analyzing one case in this thesis, not all the defense tactics were used in the literature review section. Second, describing one company in the biopharmaceutical industry in China. However, this case did not represent the common phenomena of other companies. Third, this thesis is subjectivity. A great part of information and data were collected through the telephone interview with eleven interviewees from Fangxin. Therefore, their opinions tended to be subjective.

c) Suggestions for further research

During the work with this thesis, we realized that hostile takeover is a broad subject to analyze and describe. This subject can be analyzed and described with different point of views. Taking the perspective from the bidder company is an interesting attempt. We can also analyze what actions the bidder company will take in order to fight off the defense tactics are implemented by the target company.

Besides, it is interesting to conduct similar research with multiple case-studies among different industries in China. According to these cases and the characteristic of these industries, we can find out the preference of defense tactics in each industry.

Reference

- Babbie, E. (2010). The practice of social research. United State. Wadsworth.

- Choi, A. (2004). Golden parachute as a compensation-shifting mechanism. *The Journal of Law, Economics&Organization*, 20, 171-191.

- Coop, D. R. and Schindler, P. S. (2003). Business research methods（3rd edition）. London, UK. *McGraw Hill*.

- Carolyn, C., Griffith, J. M. and Rudolph, P. M. (1998). The performance of white-knight management. *Financial Management*, 27, 46-56.

- David, S. (1997). Qualitative research: theory, method and practice. London, *Sage Publications*

- Dann, L. Y. and DeAngelo, H. (1982). Standstill agreements: privately negotiated stock repurchases and the market for corporate control. *Journal of Financial Economics*,11,275-300

- Frank, J. and Mayer, C. (1996). Hostile takeovers and the correction of managerial failure. *Journal of Financial Economics*, 40, 163-181.

- Gordon, J. N. and Kornhauser, L. A. (1986). Takeover defense tactics: a comment on two models. *The Yale Law Journal*, 96,296-321.

- Gilson, R. J. and Bernard, S. B. (1995). The Law and Finance of Corporate Acquisitions. New York, USA: *Foundation Press.*

- Gaughan, P. A. (1996). Mergers, acquisitions, and corporate restructuring. New York, USA: *John Wiley&Son, Inc.*

- Hanly, K. (1992). Hostile takeovers and methods of defense. *Journal of Business Ethics,* 11,895-913

- Heron, R, A. and Lie, E. (2006). On the use of poison pills and defense payout. *Journal of Business*, 79, 1783- 1806.

- Hussey, D. (1999). Merger and Acquisition, *Strategic Change*,8, 133-134

- Hernon, P. and Schwartz, C. (2009).Reliability and validity. *Library& Information Science Research*, 31, 73-74.

- Hirshleifer, J. (1991). The technology of conflict as an economic activity. *The American Economic Review*, 81, 130-144.

- Hitt, M. A. (2001). Mergers and Acquisitions: A guide to creating value for stakeholders. USA: Oxford University Press.

- Knoeber, C. R. (1986).Golden parachutes, shark repellents and hostile tender offers. *The American Economic Review,* 76, 155-172.

- Kirk, J. and Miller, L. (1986). Reliability and validity in qualitative research. London, *Beverly Hills.*

- McCloughan, G. (2001). Reliability and Validity, what do they mean? *Curriculum Support, Science*, 6, 1-3.

- Travlos, N. G. (1987). Corporate takeover bids, methods of payment, and bidding firms' stock returns. *The Journal of Finance,* 42, 943-963.

- Pearce, J. A. and Robinson, R. B. (2004). Hostile takeover defense that maximize shareholders wealth, Business Horizons, 47, 15-24.

- Park, S and Luo, Y. (2001).Guanxi and organizational dynamics: organizational networking in Chinese firms. *Strategic Management Journal,* 22.455-477.

- Weston, J. F. (2001). Mergers & Acquisitions. USA: *McGraw-Hill Professional Book Group.*

- Westion, J. F., Siu, J. A., & Johnson, B. A. (2004). Takeovers, restructuring, and corporate governance. Upper Saddle River,N.J.: *Prentice Hall*.

- Weston, J. F., Mitchell, M. L., & Mulheri, J. H. (2006). Takeover and corporate governance. Ndw Jersy, USA: *Pearson Prentice Hall.*

- Rose, C. (2005). Takeover defense' influence on managerial incentives. *International Review of Law and Economics*, 25,556-577.

- Roos, I. I., Nicol, J. P. and Cageorge, S. M. (1987). Using administrative data for longitudinal research: comparisons with primary data collection. *Journal of chronic diseases*, 40, 1-41.

- Ross, S. A, Wseterfield, R.W., and Jaffe, J. F. (2005). Corporate Finance 7 th Ed. New York: *McGraw-Hill/Companies.*

- Ruback, R. S. (1987). An overview of takeover defenses. *Mergers and Acquisitions, 49-68.*

- Schweiger, D.M. and Very, P. (2003). Creating value through merger and acquisition integration. *Advanced in Mergers and Acquisitions*, 2, 1-26.

- Shleifer, A and Vishny, R. W. (1986).Greenmail, white knights and shareholders' interest. *The Rand Journal of Economics*, 13, 293-309.

- Macey, J. R. (1986) Takeover defense tactics and legal scholarship: market force versus the policymaker's dilemma, *The Yale Law Journal*, 96, 342-352.

- Sinha, S. (1991). Share repurchase as a takeover defense, *Journal of Financial and Quantitative Analysis*, 26, 233-243.

- Saunders, M. and Thornhill, A. (2003). *Research Methods for Business Students (3rd edition).* London, UK. *Pearson Education Limited.*

- Mayer, C. and Jenkinson, T. (1994). Hostile takeovers: defense, attack and corporate governance (4TH edition). London,UK. *McGraw-Hill.*

- Xin, K. and Pearce, J. L. (1996). Guanxi: connections as substitutes for formal institutional support. *Academy of Management Journal*, 39, 1641-1658.

Appendices

Appendix 1 Definition and description of essential terms

Merger A merger can be described as a process when two companies join into a new company. These two companies have to mix their assets and liabilities in order to compose a new company (Hussey, 1999).

Acquisition An acquisition can be described as a process that one company acquires the control of another company through stock and shares purchase (Schweiger and Very, 2003).

Hostile takeover When one company attempts to take over another it does not involve gentlemanly negotiations and unfriendly transactions. Usually these behaviors go against the will of the target company, this takeover can be defined as a hostile takeover (Mayer and Jenkinson, 1994).

Target A company becomes an objective of takeover attempt (Hanly, 1992).

Bidder A company is trying to purchase or takeover another company **(**Hanly, 1992).

Takeover bid A bidder provides an offer to takeover target company. Takeover bid usually offer premiums to current market price. (Travlos, 1987, Mayer and Jenkinson, 1994)

Defense tactics Methods that prevent hostile takeover attempt from another company. (Pearce and Robinson, 2004)

Prevention tactics Prevention tactics can be treated as proactive steps that are taken by executives to reduce attractive as a target. (Pearce and

	Robinson, 2004).
Reaction tactics	Reaction tactics only can be adopted when hostile takeover has begun (Pearce and Robinson, 2004)

Appendix 2 Two-in-one drugs reagent testing