ENFORCING VOLUNTARY COMPLIANCE: THE NEED TO STRENGTHEN HONG KONG'S MERGER AND ACQUISITION REGULATIONS

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I. INTRODUCTION

For many years commentators on merger and acquisition activities have noted that "the Pacific Rim has been and will become increasingly important."[1] Although several countries in the region are developing internal markets for these transactions,[2] Hong Kong stands out in terms of size, volume and sophistication.[3] Recently it has outpaced other regional markets and accounts for nearly one-third of the market share in Asia for these transactions (excluding Japan).[4]

Despite the recent financial turmoil throughout much of Asia,[5] there remains reason to believe that the Hong Kong merger and acquisitions

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1. How Pacific Rim Buyers Are Hitting the World M&A Scene, MERGERS & ACQUISITIONS, July-Aug. 1990, at 26 (quoting J. Buckner Brown).

2. *Id.* at 26 (noting that "the m&a market in these newly industrialized countries [Hong Kong, Taiwan and South Korea] is growing significantly, both with respect to the number and size of transactions").

3. Foo Eu Jin, *US$73.5bn in Merger Volume in Region*, BUS. TIMES (Malaysia), Feb. 10, 1998, at 2 (noting that "In looking at Asia, Hong Kong established its position as the region's leader").

4. *Id. See generally*, Garrick Holmes, *European M&A: Still Sailing at a Good Clip*, MERGERS & ACQUISITIONS, Mar.-Apr., 1997, at 13; *Big Price Tags Make For a Banner Year*, MERGERS & ACQUISITIONS, Mar.-Apr., 1996, at 13; *A Spark of Life For European M&A*, MERGERS & ACQUISITIONS, May-Jun., 1995, at 20; *The Downward Turn of M&A in Europe*, MERGERS & ACQUISITIONS, May-Jun., 1994, at 20; *A Swifter Pace Of Cross-Border M&A*, MERGERS & ACQUISITIONS, May-Jun., 1993, at 21.

5. See Neel Chowdhury & Anthony Paul, *Where Asia Goes From Here*, FORTUNE, Nov. 24, 1997, at 96.

market will continue to grow.[6] As China further liberalizes its economic policies and especially since Hong Kong has reverted to Chinese sovereignty, many mainland firms are looking overseas and commencing operations in Hong Kong.[7] This is creating many potential new acquirers, targets, and increasing number of formerly rare transactions such as hostile takeovers and leveraged buyouts.[8] Yet these changes also have the potential to slow or halt the development of this important financial market segment if not appropriately regulated. Perhaps reflecting this, Hong Kong's Securities and Futures Commission recently announced that it would review the Hong Kong Code on Mergers and Takeovers (the "Code") for the first time since 1992.[9] Although the modifications discussed thus far by the Commission are limited in scope,[10] a broad-based review and revamping of the regulatory system could be beneficial and bring the regulation of merger activity into closer harmony with the dramatic differences in the business and political environment since the Code was first put in place.

This article sets out to describe both the current regulatory system and the developments that threaten to undermine efficient regulation of the market for corporate control in Hong Kong. It then argues that implementation of an enforcement regime based on legal authority and sanctions rather than voluntary compliance would best serve Hong Kong's future needs.

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6. *Turmoil Prompts Spate of Mergers, Acquisitions*, HONG KONG STANDARD, Oct. 23, 1998.

7. Mark Clifford, *Can Hong Kong Learn To Behave?*, BUS. WK., Sept. 2, 1996, at 42.

8 *See* Louise Lucas (quoting Eamonn McManus), *M&A Culture Taking Root*, FINANCIAL TIMES, Apr. 29, 1996, at 6 (noting that "'contested takeovers are a rarity in this part of the world' . . . However, there are signs that this may be changing"); Michael Garner (quote), *Roundtable: How Pacific Rim Buyers Are Hitting the World M&A Scene*, MERGERS & ACQUISITIONS, Jul./Aug. 1990, at 26 (noting that "there is a trend by controlling shareholders to take publicly traded companies private.").

9. Enoch Yiu, *SFC is to consider new rules*, S. CHINA MORNING POST, Feb. 11, 1998, at 2.

10. *See* Enoch Yiu, *Sfc Seeks to Change Rules of Privatization*, S. CHINA MORNING POST, Feb. 13, 1998, at 3 (noting that the Commission has proposed changes to the shareholder approval level required to take a company private "as part of its review of the Hong Kong Code on Takeovers and Mergers").

II. CURRENT HONG KONG MERGERS AND ACQUISITIONS REGULATORY ENVIRONMENT

Compared to other jurisdictions, "on the whole, the acquisition of Hong Kong companies and assets . . . is not heavily regulated."[11] Only a few legal documents have direct application to these transactions, namely the Companies Ordinance,[12] the Securities Ordinance,[13] and the Protection of Investors Ordinance.[14] Their provisions are general rather than directed specifically at regulating mergers and acquisitions.[15]

As a result, the bulk of Hong Kong's mergers and acquisitions regulatory system is set out by a non-legal document, the Hong Kong Code on Takeovers and Mergers. Not surprisingly for a former British colony, the Code was "designed as similar in form and effect to the London City Code in the United Kingdom."[16] Instead of being a legally enforceable set of rules and regulations as in the United States,[17] Australia[18] or Singapore,[19] the Code states that its object "is to provide guidelines for companies and their advisers contemplating or becoming involved in takeovers and mergers affecting public companies in Hong Kong. The Code does not have, nor does it seek to have, the force of law."[20]

11. Leslie Simon, *Major Legal Issues: Hong Kong*, INT'L BUS. ACQUISITIONS, 1996, at 112.

12. Sections 167, 168 and the Ninth Schedule of the Companies Ordinance contain provisions dealing with the rights of minority shareholders in the event of offers for all shares (or all shares of a particular class of stock) of a company. In particular, these provide that dissenting shareholders have the right to be bought out on the same terms as those given to the majority shareholders (unless the dissenters agree to, or a court specifies, different terms) whenever an acquirer purchases 90% or more of the target's shares and that if the majority group was given a choice between different forms of consideration, dissenters must get the same choice.

13. Primarily by requiring disclosure of certain types of information.

14. Notably by criminalizing unjustified, reckless, or false forecasts, statements or promises.

15. Originally the Securities Ordinance intended to regulate takeovers, but "there was much opposition to this proposed regulation, and the take-over provisions of the draft bill never became law." *See* H. LEIGH FFRENCH, INTERNATIONAL LAW OF TAKEOVERS AND MERGERS: ASIA, AUSTRALIA, AND OCEANIA 56 (1986).

16. *Id.*, at 64.

17. *See* 1968 Williams Act Amendments to the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C.A. §78 (1994).

18. See the Companies (Acquisition of Shares) Act (Austl.).

19. FFRENCH, *supra* note 15, at 93 n. 2. (arguing that Singapore's Takeover and Merger Code utilizes both the U.S. and the British approaches to regulating these transactions by combining provisions based on the London City Code with statutory regulation and legal enforcement.)

20. HONG KONG CODE ON MERGERS AND TAKEOVERS, §1.

As a former member of Hong Kong's Committee on Takeovers and Mergers (the "Takeovers Committee")[21] notes, "the Code, then, is not legally enforceable. No one can be prosecuted for not complying with it, nor can any party bring an action in law seeking to rely upon it to enforce a contract or to avoid an obligation."[22] The Code's only means of encouraging or enforcing compliance is the power of the Takeovers Committee to privately or publicly censure parties that breach its provisions.[23] Professional disapproval of such actions provides further incentive and there is always the possibility that other organizations, such as Hong Kong's stock exchange, would "add the sanctions of delisting and punishment of brokers to the Committee's powers of public and private censure."[24] However, this lack of direct legal sanctions has led commentators to say that "there are great rules on the books, but [they have] no teeth."[25]

Organizationally, the Code is divided into "General Principles", which define "acceptable standards of commercial behavior",[26] and "Rules" that provide either specific procedures to follow or give "examples of the application of the General Principles."[27] Mere technical compliance is not sufficient since General Principle 1 mandates that parties "observe the spirit as well as the precise wording of the General Principles and the Rules."[28] Arguably this method avoids the necessity for complex technical regulations and makes compliance and enforcement easier and more efficient.[29] However, such a system assumes a certain shared value system and cultural norms that, for various reasons, may no longer exist.[30] Still,

21. The Takeovers Committee administers the Code pursuant to Section 16 of the Securities Ordinance, which allows the Securities Commission to establish and delegate responsibility to committees that may regulate their own procedure as they see fit. DEREK J.M. MURPHY, A GUIDE TO THE HONG KONG CODE ON TAKEOVERS AND MERGERS 5 (1988).

22. *Id.*, at 4.

23. FFRENCH, *supra* note 15, at 64.

24. *Id.*, at 93.

25. Clifford, *supra* note 7, at 42 (quoting an unnamed Western analyst).

26. Introduction, Hong Kong Code on Mergers and Takeovers, §2.

27. FFRENCH, *supra* note 15, at 64.

28. General Principle No. 1, HONG KONG CODE ON MERGERS AND TAKEOVERS.

29. FFRENCH, *supra* note 15, at 69.

30. For instance, one interpretation of the "spirit" of the Code is to "render liable any unethical or dishonest conduct." FFRENCH, *supra* note 15, at 69. To the extent that firms from parts of the world where cultures and business methods differ substantially from those practiced in Hong Kong now operate there, forming a consensus on the meaning of the "spirit" of the Code may be difficult. *See also* Kenneth U. Surjadinata, *Revisiting Corrupt Practices From A Market Perspective*, 12 EMORY INT'L L. REV. 1022 (1998) (arguing that cultural and moral conflicts make differences regarding the acceptability of particular business practices irreconcilable except by recourse to

the Code attempts to ensure an efficient marketplace in which acquirers can make offers without interference from target management and in which target shareholders can make decisions without undue coercion from acquirers.

To achieve this, acquirers are required to disclose information necessary for the target's shareholders to evaluate the offer and reach an informed decision.[31] The offer must remain open for a minimum length of time and unequal offers to different shareholders are forbidden.[32] Target boards may make recommendations regarding offers to their shareholders, but must submit bids to shareholder vote and may not take action to discourage the making or completion of bids.[33] In practice, this means that target boards may not simply turn down a bid they consider insufficient or implement defensive tactics.[34] Target boards may seek out other bidders or create an auction, but helping favored bidders, such as by granting asset lockups or providing better information than that given to disfavored bidders, violates the Code.[35]

III. RECENT CHANGES IN THE HONG KONG MERGERS AND ACQUISITIONS ENVIRONMENT

As discussed above, since adoption of the Code in 1981, merger and acquisition activities in Hong Kong have increased substantially, to the extent that, as early as 1990, the colony was viewed as "having an internal m&a market."[36] However, recent trends suggest that continued growth may require modifications of the regulatory system. Among them, particularly worrisome are (1) the increase in PRC firms operating in Hong Kong, (2) closer ties to the PRC leading to increased corruption or inefficient regulation, and (3) concern that the system of voluntary

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efficiency based criteria).

31. *See* FFRENCH, *supra* note 15, at 55. (General Principle Number 4. This even overrides Hong Kong's long standing practice of allowing anonymity in share ownership (by not requiring disclosure of beneficial ownership of shares) since Rule 2 of the Code mandates that in situations where "an offer being made is not made by the ultimate offeror or potential offeror, the identity of that person must be disclosed at the outset to the board of the offeree company.")

32. HONG KONG CODE ON TAKEOVERS AND MERGERS, §30 and §31.

33. *See* MURPHY, *supra* note 21, at 35 ("Anything done to frustrate a bona-fide offer being placed before shareholders for their earnest consideration would be a breach of the Code").

34. HONG KONG CODE ON TAKEOVERS AND MERGERS, §10.

35. *Id.*, §10(iv) and §13.

36. *How Pacific Rim Buyers Are Hitting the World M&A Scene*, MERGERS & ACQUISITIONS, Jul.-Aug., 1990, at 26.

compliance with the Code could break down. Such issues, if unaddressed, could slow merger and acquisition activities in Hong Kong, or even lead to a rapid exodus of investment capital and an eventual stagnation or collapse of the market.

A. *Increasing Numbers of PRC Firms Operating in Hong Kong*

1. Reasons PRC Firms Come to Hong Kong

The increasing number of PRC firms looking to Hong Kong both to expand their operations and to raise capital could bring about significant changes in the merger and acquisitions environment. Many of these firms' interest in Hong Kong stems from a need for access to capital, markets and skilled personnel, all of which are in short supply on the mainland. Their inflow has already been tremendous and is expected to continue to increase. As reporter Mark Clifford noted, "Chinese companies have already raised more than $3.5 billion by listing H shares in Hong Kong. More are on the way as the colony tries to nail down its position as China's financial capital."[37] Moreover, along with small corporations, the large mainland government monopolies have also begun to move in. As one commentator explains, "the advent of Chinese rule has already introduced to the market new players controlled by various ministries and government departments."[38]

Access to new sources of capital drives the decision of many of these firms to operate in Hong Kong, especially since "the tighter conditions get in China, the more desperate the search for capital becomes."[39] Despite economic reforms and foreign investment, capital markets in the PRC remain tight. This is especially true for small firms which lack substantial government support and do not have foreign joint venture partners. Such firms are squeezed for cash and often "can't even get permission to list in the Shanghai and Shenzhen markets."[40] Larger PRC companies also face the same problems, particularly in light of recent attempts by the central government to reform the PRC banking system. Consequently, few of these companies have the capital to expand overseas or reach economies

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37. Clifford, *supra* note 7, at 42.

38. William McGurn, *Diminishing Returns*, FAR E. ECON. REV., Jun. 13, 1996, at 66.

39. Bruce Einhorn, *The China China Connection*, BUS. WK., Aug. 5, 1995, at 32 (quoting James Haft, managing director for emerging-markets investment banking at Furman Selz).

40. *Id.*, at 32.

of scale.[41] To them, the recently liberalized listing requirements of the Hong Kong stock exchange look particularly attractive and many have continued to list on the Hong Kong market despite its recent turmoil and sharp declines in valuation.[42]

Access to new markets also plays a role. Ironically, while foreign firms search for ways to enter PRC markets, some PRC firms are going in the other direction.[43] To some extent this is a matter of economics. Large and relatively efficient foreign firms see China first as a huge and rapidly expanding market for their products, and only secondly as a source of cheaper labor and lower production cost.[44] PRC firms, quite differently, see Hong Kong as a bridge to developed nations where they can achieve higher product margins and where their low manufacturing costs help them compete.[45] For instance, Richard Lesher, president of the U.S. Chamber of Commerce, noted that "the U.S. market is even more important to China's growing economy [than the Chinese market is to U.S. firms]. Roughly one-third of Chinese exports - mainly textiles and footwear - are sold to Americans."[46] By entering the Hong Kong market, these firms may feel better positioned to expand elsewhere.

The availability of better management and technical personnel interacts with the above factors, providing a further incentive for PRC firms to operate in Hong Kong.[47] A severe shortage of talented and qualified people has become a major bottleneck for both local and foreign

41. Hong Yong, *China: Shenzhen Bracing for JV Traders*, BUS. WK. (China Daily supp.), Nov. 10, 1996.

42. John Ridding, *Peregrine's Grim Lessons*, FIN. TIMES (LONDON), Jan. 23, 1998, at 12. (noting that such firms include China Telecom, "the biggest ever 'red chip' to list in the territory, during the severe market turmoil of last October", and CNAC, "the commercial arm of China's aviation regulator").

43. Gareth Hewett, *Unique Ingredients, Perfect Recipe*, SUNDAY MORNING POST, Jul. 21, 1996, at 3 (noting that mainland firms have invested heavily and won "significant shares of several key markets in Hong Kong").

44. This is due in large part to reports produced by consulting firms and the media, which often stress China's size and potential while downplaying its lower living standards and disposable income, since these decrease the viability of selling products there. Since multinational firms often face static (or at best very slowly growing) market share for their products in the developed nations, the prospect of undeveloped markets has become more attractive than cost savings from reduced labor and production costs. *See* William Miller, *Demystifying the Far East*, INDUSTRY WK., Jun. 5, 1995, at 36.

45. Lu Ping, *Deng Ensured HK's Special Status*, S. CHINA MORNING POST, May 7, 1994, at 4.

46. Richard Lesher, *Should Congress Grant Permanent 'Most Favored Nation' Status to China?*, WASH. TIMES, Jan. 6, 1997, at 24.

47. Lucas, *supra* note 8, at 6.

firms to expand within the PRC.[48] Trained personnel are increasingly important as PRC firms face stronger competition,[49] and are forced to "improve internal management, cut costs and rework the structure of their export commodities."[50] Hong Kong offers numerous such individuals concentrated in a small area (many of whom received their training overseas in the United States or other developed nations). The higher living standards available in Hong Kong also aid in the retention of these individuals once hired.

2. Effects on the Mergers and Acquisitions Environment

The potential effects upon the Hong Kong mergers and acquisitions environment from the growing presence of PRC firms are both tactical and strategic. Strategically, the influx of new small firms seeking capital increases the number of potential targets as such firms become exposed to acquirers which, on the mainland, they were largely shielded from.[51] In addition to their need for capital, which makes them somewhat vulnerable, some of these firms are quite desirable to acquirers for the very reasons that brought them to Hong Kong in the first place - undeveloped overseas markets for their products and shortages of trained personnel. These difficulties provide opportunities for a successful acquirer to improve the target company's operations and increase its profitability, thereby justifying the acquisition financially or by making it easier to pay off the premium incurred when purchasing the firm.

Larger PRC firms, especially state owned enterprises, can be expected to have a different strategic effect in that they are more likely to act as acquirers and use direct and/or reverse mergers to enter Hong Kong, possibly at below-market prices obtained through connections and pressure.[52] Reverse mergers have even been used by some of these firms to reach the U.S. capital markets, generally by "forming a joint venture with overseas partners, often Hong Kong-based subsidiaries of Chinese outfits. That turns [the PRC firm] into an overseas joint venture, beyond

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48. Miller, *supra* note 44.

49. Kevin Hamlin (quoting Jeffrey E. Garten, United States Undersecretary for the International Trade Administration), *Taking Chances in China*, INT'L BUS., Dec. 1994, at 48.

50. Yong, *supra* note 41.

51. *See* HONG KONG STANDARD, *supra* note 6 (noting that in 1998 most merger and acquisition transactions in Hong Kong have been Hong Kong firms buying PRC companies).

52. BRUCE B. DE MESQUITA ET AL., RED FLAG OVER HONG KONG 140 (1996) (noting the possibility of "bargain-basement purchases of stakes in Hong Kong-listed firms by mainland enterprises").

the reach of Beijing's regulators. The new company finds an American shell, buys out the old owners, changes the name and management, and starts doing business as a new U.S. company."[53]

In addition to the strategic effects, there are several potential tactical problems posed by activities of PRC firms in Hong Kong, either as targets or acquirers. One such problem is the use of different and often less stringent accounting standards by PRC firms. Many PRC firms currently do not disclose or compile accounting information about themselves in the manner required of non-PRC firms and are not likely to do so in the near future. Although debate has already arisen over whether to lower Hong Kong standards to accommodate them, PRC firms have generally not been required to conform, despite complaints.[54] The lack of accurate and readily comparable accounting information hampers merger and acquisition activities by making it harder to accurately value firms involved. This has in turn dissuaded potential acquirers from bidding since they cannot be sure of the basic economics underlying the transaction or avoid overpaying. If the takeover goes forward anyway, inaccurate or unavailable information about the target increases the difficulty faced by acquirers in raising money to fund the acquisition from sources other than cash on hand.[55] As a related point, merger and acquisition activities involving PRC firms have been further hampered "by fears of investors that they may inherit hidden liabilities of Chinese companies by buying shares."[56] So long as inconsistent accounting standards and lax enforcement of disclosure requirements persist, PRC firms may be targeted less by acquirers and market efficiency is thereby reduced.

The accounting issues also lead to valuation differences that affect these transactions. For instance, "differences between China's accounting practices and international methods [mean] enterprises could be significantly undervalued,"[57] making their acquisition cheaper. In contrast, systematically overvaluing firms would produce the opposite result, making them costlier to acquire and enhancing their ability to acquire other firms. Overvaluation is particularly serious with PRC firms entering Hong Kong, as some industry experts noted that "Chinese valuations [are]

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53. Einhorn, *supra* note 39, at 32.

54. Clifford, *supra* note 7, at 42.

55. Methods such as selling securities or taking on debt are difficult since lenders and investors are hesitant to fund an acquisition without assurance that it makes sense economically.

56. Renee Lai, *Overseas Activity in M&A 'Alive and Well*, S. CHINA MORNING POST, Feb. 23, 1996, at 3.

57. Christine Chan, *Asset Losses Feared from Mergers*, S. CHINA MORNING POST, Nov. 15, 1995, at 5 (quoting William Yuen, senior consultant for corporate finance at Arthur Andersen).

generally 20 to 30 percent higher than those done by western surveyors."[58] Disputes in valuation create points of contention among shareholders and possibilities for corporate directors to unfairly transfer target corporations to preferred acquirers.[59] Inaccurate valuation also creates market inefficiency by inhibiting beneficial acquisitions while encouraging misguided ones.

Increasing cultural differences could also complicate mergers and acquisitions, because many PRC firms are in their actual operations and corporate governance more like close corporations than public firms and are not accustomed to having outside directors on the board or acting "responsibly" toward public shareholders (as the term is used in Western capital markets). Small PRC firms in particular "tend to be family-run and controlled."[60] Sometimes, even large state owned firms still function like a close corporation since they are often controlled by elements of the PRC government.[61] The "culture clash" such firms might suffer when operating as public corporations could manifest as disregard for the best interest of the shareholders when faced with a takeover proposal, as by employing excessive defensive tactics or attempting to cut private deals. Obviously these actions would violate the Code, but as discussed below, it remains questionable whether firms will obey the existing takeover regulations at all.

Arguably, these issues may be less of a problem in Hong Kong than elsewhere since, throughout its history, the Hong Kong market has functioned relatively efficiently[62] despite the fact that many publicly traded Hong Kong firms have been family-controlled.[63] Certain regional investment bankers predict that this will continue to be the case, emphasizing that they "see the family-rooted company remaining very strong, even among the major companies of Hong Kong."[64] Nonetheless, as asserted by others, size may force changes because "once you reach a

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58. Don Lyons (quoting Brett Shadbolt, valuation expert at Chesterton Petty), *China Ventures Face Snag Over Asset Valuation*, S. CHINA MORNING POST, Oct. 30, 1996, at 3.

59. In other jurisdictions, litigation by either shareholders or disgruntled would be acquirers would almost certainly ensue, especially if the board of a target corporation turned down a takeover bid based on different valuations.

60. Lucas, *supra* note 8, at 6.

61. *See* Einhorn, *supra* note 39, at 32 (noting that "with China, many investments are spurred by government owned entities").

62. As noted above, though, merger and acquisition activity in the past was relatively insignificant, perhaps due to the prevalence of close/family controlled corporations.

63. *See* YASH GHAI, THE RULE OF LAW AND CAPITALISM: REFLECTIONS ON THE BASIC LAW 359 (1993).

64. *Supra* note 37, at 26.

certain size in critical mass even though a company is family controlled it cannot be run as a family business if it is to expand. The first step is to take professional management of international standing and to be able to access levels of expertise and technology."[65]

B. Closer Ties to the PRC

1. Corruption

Another post-transition trend has been increased contact between Hong Kong and the PRC, raising related concerns that it could increase inefficiency and corruption.[66] Such concerns arise because the lack of effective regulation against corruption within the PRC has provided a vivid example of what could result.[67] These concerns are also worrisome because "corruption and inefficiency are [already] deeply ingrained in Hong Kong's financial system . . . [I]f standards become even more lax as China uses Hong Kong to raise capital for its fast-growing young companies, the colony could revert to a regional backwater instead of evolving into a global power."[68]

The hardest type of corruption for Hong Kong to deal with would be intervention or interference by Beijing itself, especially through the expropriation of the assets of firms operating in Hong Kong. Overt expropriation has of course not occurred and remains highly unlikely, both because of the pledges advanced by Beijing that Hong Kong's culture will be left intact for fifty years following resumption of Chinese sovereignty,[69] and because of the potential backlash that could destroy much of Hong Kong's value. However, less obvious forms of nationalization may already be occurring.[70] For instance, it has been suggested that the actual reason behind China National Aviation Corporation's application for a license to operate in Hong Kong, was to impose competitive pressure upon Cathay

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65. Lucas, *supra* note 8, at 6 (quoting Eamonn McManus, director of corporate finance, HSBC Investment Banking).

66. Such worries began to be raised well before transition. *See* Martin Q.C. Lee, *Business and the Rule of Law in Hong Kong*, 30 COLUM. J. WORLD BUS. 28 (1995); Clifford, *supra* note 7, at 42.

67. *See* DE MESQUITA, *supra* note 52, at 138 (arguing that corruption in China is endemic and that "only the rare case of official corruption is prosecuted, and this is largely for political show").

68. Clifford, *supra* note 7, at 42.

69. *See* Simon, *supra* note 11, at 123.

70. *See* William McGurn, *Diminishing Returns*, FAR E. ECON. REV., Jun. 13, 1996, at 67 (quoting Miron Mushat, managing director and chief economist for Lehman Brothers, characterizing discounted acquisitions of Hong Kong firms by PRC companies as "a form of nationalization").

Pacific Airways in order to "force a sale of additional shares in Cathay Pacific to Chinese interests at a preferential price to ensure a majority Chinese stake in Cathay."[71] Other firms have expressed concerns about this sort of pressure by transferring assets and currency (or the entire firm headquarters in one case)[72] to other locales, or even "[taking] the unusual step of ensuring their contracts are not subject to the jurisdiction of local courts."[73] As a clear example, a pre-transition study found that "about half of all the 529 companies listed on the Hong Kong stock exchange also have legal status in Bermuda or the West Indies, a sign that they are positioned for quick flight."[74]

Unequal enforcement of regulations and customs relating to mergers and acquisitions is also potentially troublesome, especially because, as discussed above, the Code "does not have . . . the force of law" and is not a legal document.[75] As a result, its post-transition status is somewhat less assured than Hong Kong's laws (which remain in effect so long as they do not conflict with the Basic Law and are not amended by the Hong Kong legislature).[76] Nonetheless, an argument can be made that, since it was published in conjunction with the creation of the Takeovers Committee, the Code should have "at least statutory backing" even though it is not "itself a statutory body in the sense of being specifically created by statute."[77] This implies that the Code would at least survive in the immediate future, barring any specific action to the contrary. In fact, so far, no challenge has yet been made to the Code's post-transition legitimacy.

Still, to remain effective, the Code's provisions must continue to be enforced even-handedly and without bias. As Richard Lesher, President of the U.S. Chamber of Commerce, put it, "Chinese authorities . . . need to become acquainted with the unfamiliar concept of applying laws and regulations uniformly and fairly."[78] Others have made the same point, noting that "market insiders now fear that well-connected Chinese will get

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71. DE MESQUITA, *supra* note 52, at 125.

72. *Cathay Pacific: Boarding for Beijing*, THE ECONOMIST, May 4, 1996, at 65 (noting Jardine Matheson, which also delisted its companies from Hong Kong's stock exchange).

73. Lee, *supra* note 67, at 28 (quoting Hong Kong Attorney General Jeremy Matthews).

74. Kevin Hamlin, *Greater China's Business Future*, INT'L BUS., May 1995, at 32.

75. HONG KONG CODE ON TAKEOVERS & MERGERS, §1.

76. Simon, *supra* note 11, at 123. The Code clearly does not fit into the types of pre-existing laws protected by Article 8 of the Basic Law ("common law, rules of equity, ordinances, subordinate legislation, and customary law").

77. MURPHY, *supra* note 21, at 5.

78. Richard Lesher, *Should Congress Grant Permanent 'Most Favored Nation' Status to China?*, WASH. POST, Jan. 6, 1997, at 24.

special treatment from Hong Kong regulators."[79] Such special treatment could take a variety of forms, such as subtle and indirect interference. Indirect interference could include leaking of information confidentially discussed with the Takeovers Committee in compliance with the Code to favored parties[80] or failure to give disfavored parties access to information the disclosure of which is required under the Code. More direct forms of the coercion may be possible as well, such as the interference with the business activities of targets or acquirers through denial of permits,[81] cancellation of leases,[82] and pressure placed upon customers and suppliers. It would only take a few leaks or instances of unequal enforcement to erode the willingness of business people and professionals to comply with the Code. All these could lead to the complete ineffectiveness of the Code since, "to be effective, [the Code] must, of necessity, rely to a large extent on those who are involved in the professional business of advising others on takeover activity in its widest sense to abide by its tenets and to observe its strictures."[83]

The lingering threat of substantial changes in Hong Kong's judicial system makes this prospect even more worrisome.[84] Before transition, commentators noted that "Hong Kong's fair and efficient legal system, the bedrock of its economic success, is earmarked to be one of the first casualties when China takes over",[85] and that Beijing was "actively trying to control Hong Kong's legal and political systems - the legislature, the Court of Final Appeal, the civil service - and to control Hong Kong's laws."[86] Although opinions differ as to the worth of Hong Kong's current judicial system and how much of a role it has played in Hong Kong's success,[87] reduced independence of the judiciary could nonetheless easily

79. Clifford, *supra* note 7, at 42.

80. Currently members of the Committee on Takeovers and Mergers are "subject to the secrecy provisions of Section 19 of the Securities Ordinance" and must keep confidential information received by them pursuant to provisions of the Code. *See* MURPHY, *supra* note 21, at 6.

81. DE MESQUITA, *supra* note 52, at 125 (such as the closing of the Beijing branch of Giordano for "lack of proper registration).

82. *See* Lee, *supra* note 66, at 28 (discussion of the cancelation of McDonald's corporation's twenty-year lease).

83. MURPHY, *supra* note 21, at 4.

84. *See* Steve H. Hanke, *The Curse of Corruption*, FORBES, Jul. 29, 1996, at 103 (noting the importance of the judiciary and the rule of law for dealing with and reducing corruption).

85. Lee, *supra* note 66, at 28.

86. *Id.*

87. *See* GHAI, *supra* note 63, at 359 (suggesting that "the common law has not been particularly relevant to the development or the operation of the market in Hong Kong").

affect the completion of mergers and acquisitions. For instance, provisions of the Basic Law allow judges to be removed for a variety of reasons, suggesting that "judges who want to keep their seats will be under tremendous pressure to find in favor of the Chinese government on major cases, or those in which a lot of money is at stake."[88] Merger and acquisition transactions often meet both criteria.

An inability to rely on the enforcement of legal agreements could affect merger and acquisition tactics in several ways, mostly by limiting the effectiveness of defensive tactics that largely rely on judicial enforcement of the Code's provisions. Provisions in bylaws that require super-majorities or a majority of shares other than those owned by the acquirer for shareholder approval of certain actions (typically mergers, buyouts, or sale of substantially all of a firm's assets) could be vulnerable. For example, given the autocratic ways in which many of the region's firms are run, conflict could arise if a PRC firm purchased what it believed to be a controlling or majority interest in a Hong Kong firm only to find that its intended merger was blocked by recalcitrant shareholders and the above bylaws or charter provisions.[89] Similarly, provisions implementing a staggered board of directors could be an issue, since these provisions can delay the exercise of control by an acquirer for two or more years. In the case of other controversial defensive tactics, such as breakup fees, poison pills, and asset lockups, it could be even easier for judges under pressure to find ways to avoid enforcing them.

2. Inefficient Regulation

Apart from corruption, future political interference with Hong Kong mergers and acquisitions regulation could result in decreased efficiency because of over-regulation and the use of regulations that are incompatible with those of other countries. This is not a new problem; it has long been observed that "acquirers moving beyond their borders into other countries often run into regulatory systems for acquisitions, generally, as well as for transactions in regulated industries that not only differ but conflict with the requirements in their home lands . . . [I]n short, what is allowed in one

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88. Lee, *supra* note 66, at 28.

89. Interestingly, provisions in the Code dealing with similar issues (those requiring ninety percent shareholder approval for attempts to take a public company private) have already been selected for review by the Commission, and the proposals thus far advanced have aimed at reducing the required approval percentage or limiting its applicability. *See* Yiu, *supra* note 9.

jurisdiction may be forbidden in another."[90] In the past, Hong Kong's permissive takeover regulations have generally minimized such problems. The PRC however, regulates takeovers far more extensively than Hong Kong; yet it still lacks substantial experience with mergers and acquisitions.[91] Thus inefficiency is possible, especially when PRC firms are involved in the transactions, to the extent that less experienced and/or politically motivated PRC officials manage to directly or indirectly involve themselves in Hong Kong merger regulation.[92]

Concern about takeovers in the PRC is understandable and has largely revolved around "Beijing's fears that state assets were leaking away to foreign investors."[93] Such fears could easily expand to include Hong Kong inasmuch as at least one study estimates that about HK$ 278.7 million is lost daily "through asset restructuring that involves foreign-funded companies."[94] As PRC firms operate in Hong Kong and become exposed to takeover activity there, Beijing may take a special interest in transactions targeting these firms. Although its ability to directly affect transactions remains limited, provisions of the Basic Law allowing the PRC to intervene in situations involving issues of national security are ominous in this regard.[95] For instance, the PRC could assert that foreign takeovers of certain PRC firms affect its national security.[96] Such claims would be especially likely in the case of firms owned or operated by the Peoples' Liberation Army or other state owned enterprises which the PRC might

90. Meredith M. Brown and Simon MacLachlan, *Legal Headaches for Buyers Going Into Foreign Lands*, MERGERS & ACQUISITIONS, Mar.-Apr., 1991, at 57.

91. Joyce Barnathan, *The Next Hot Spot for M&A: Shanghai*, BUS. WK., Mar. 13, 1995, at 56 (noting that the PRC "has nothing that can be called an M&A market... to date, most mergers have been forced by the government, which urges a strong company to take over a faltering one").

92. Such involvement would also increase the possibilities for corruption. *See* Vito Tanzi, *Corruption, Governmental Activities, and Markets*, FIN. & DEV., Dec. 1995, at 26; Francis Lui, *Three Aspects of Corruption*, CONTEM. ECON. POL'Y, Jul. 1996, at 26.

93. Lai, *supra* note 56, at 3.

94. Chan, *supra* note 57, at 5.

95. For instance, Article 18 of the Basic Law, which provides that "the Central People's Government may issue an order applying the relevant national laws" if "turmoil" or a "state of emergency" exists in the Hong Kong Special Administrative Region, or Article 19 of the Basic Law which requires Hong Kong courts to "obtain a certificate from the Chief Executive on questions of fact concerning acts of state such as defense and foreign affairs whenever such questions arise in the adjudication of cases" and makes this certificate "binding on the courts." Article 19 further requires the Chief Executive to "obtain a certifying document from the Central People's Government" before issuing certificates, thus ensuring Beijing's control.

96. This is not an uncommon position for a government to take. The U.S., for example, has raised issues of national security in blocking the sale of certain U.S. firms (generally defense contractors) to foreign owners. *See* In re Chateaugay Corporation, 186 B.R. 561, 564 (1995) (describing two such instances).

well argue constitute "state assets". Even before transition, the PRC asserted that its consent was necessary in connection with several Hong Kong transactions involving public utilities, infrastructure, and telecommunications.[97]

One strategy firms already employ to cope with these issues is the inclusion of individuals with strong connections to the PRC in their boards of directors.[98] Conversely, the PRC may (explicitly or otherwise) make inclusion of such individuals (or exclusion of disfavored persons)[99] a requirement for firms seeking government contracts or permits in Hong Kong or the mainland. This parallels past efforts and allows Beijing to exert further, but less publicly visible, influence upon firms.

C. Non-Compliance with the Code

To the extent that PRC companies operating in Hong Kong benefit by simply ignoring the "voluntary" rules of the Code, the likelihood that other firms will follow suit increases. Non-compliance with mandatory rules has largely gone unpunished. So far "none of the Chinese companies listed in Hong Kong . . . has received more than a slap on the wrist from regulators. Yet their numerous and flagrant violations of Hong Kong rules range from failing to disclose major events in a timely manner to misusing proceeds from an initial public offering."[100] Arguably, many of these violations probably stem from the differences discussed above between business practices and culture in the PRC and Hong Kong (as well as between operating as a public company versus a private firm) and may decrease as firms become accustomed to the standards expected of them. If, however, widespread disregard for the provisions of the Code becomes the norm among non-PRC firms as well, certain currently disfavored offensive and

97. For instance, the new airport, the proposed Western Corridor Railway, and the battle over Hongkong Telecom. *See* Gary Silverman, *Miles to Go: Beijing's Suspicions Cloud Hong Kong Rail Plan*, FAR E. ECON. REV., June 13, 1996, at 69; McGurn, *supra* note 39, at 66; Carolyn Koo, *A PRC Partner for Hongkong Telecom?*, INSTITUTIONAL INVESTOR, June 1996, at 171 (noting that "to many observers it seems inconceivable that Beijing will allow Hong Kong's dominant telecommunications company to remain in foreign (especially former colonial) hands").

98. Note Swire Group's inclusion of PRC connected persons in its board of directors (though this arguably was a mixed blessing for Swire at best). *See* ECONOMIST, *supra* note 72, at 65. *See also* DE MESQUITA, *supra* note 52, at 140 (noting the possibility of "appointments of mainland officials to the boards of directors of Hong Kong companies").

99. *See* DE MESQUITA, *supra* note 52, at 125. (noting Jimmy Lai's sale of his controlling interest in Giordano (which he originally founded) following a dispute with Beijing authorities arising after he made comments critical of Deng Xiaoping).

100. Clifford, *supra* note 7, at 42.

defensive tactics could become troublesome.

One such disfavored practice is that of "front-loaded" or coercive offers.[101] These transactions, common in the early days of securities markets, involve an offer to purchase a controlling amount of shares coupled with the statement that the price offered will not be available after a control block has been acquired, or after a short period of time. There is also often an understanding that the offer will be followed by a freezeout merger at a lower price. Such offers pressure shareholders to tender their shares immediately since delay could result in a loss of not just the initial price, but also a forced sale at the lower freezeout price. In practice, this tends to adversely affect the ability of a firm's board of directors to create an auction or otherwise assist shareholders in getting the best price possible.[102] The result is that even "low-ball" bids may succeed.

Front-loaded offers gain much of their power from the uncertainty that surrounds the valuation of a corporation, especially in a highly time-pressured situation or when a hostile offer is made.[103] This uncertainty arises even in well-developed securities markets with extensive and well-enforced disclosure requirements. But it is particularly likely to prove troublesome in Hong Kong where substantial discrepancies routinely arise in firm valuations.[104] Moreover, political risk affects the valuation of a firm and could add greatly to the coercive power of offers targeting foreign firms since Western investors appear to perceive higher political risk in Hong Kong than Chinese investors.[105]

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101. These transactions are forbidden by General Principle Number 4 of the Code, which requires that "shareholders must be given sufficient time to consider [the offer] properly." Securities laws in most other major markets also ban these transactions, whether through similar general principles (Britain) or statutes (the United States and Australia).

102. It does so both by decreasing the time available to the board or to shareholders to seek or evaluate competing bids, and by decreasing the willingness of other potential acquirers to make an offer since the purchaser that made the "front-loaded" offer already has a substantial advantage. Moreover, the time pressure impedes communication between the board and shareholders, as well as accurate analysis of the sufficiency or viability of the bid.

103. Obviously, if a firm's value could be objectively calculated in a manner that everyone involved agreed with, offers below this value would have little chance of success (since shareholders could rationally expect that other shareholders would not sell for less than this price). Unfortunately, most transactions lack such unanimity on the value of the target firm. This puts pressure even on optimistic shareholders, since they cannot be sure that other shareholders share their assessment of the firm's value.

104. *See* Lyons, *supra* note 58. Non-compliance with disclosure regulations would also foster uncertainty.

105. Miller, *supra* note 44, at 36 (quoting Kal Kuan, general manager and director of Guangzhou Nanfang Transmission Systems Co., a Guangzhou, China-based joint venture of Siemens AG).

Other generally forbidden practices such as "unequal offers" and "creeping control acquisitions" differ from front-loaded offers in that they gain their primary effectiveness from weak or non-existent disclosure regulations. Unequal offers refer to the practice of some acquirers to offer different prices or terms for identical securities to various groups of shareholders in connection with an acquisition. For instance, a group or individual holding a large block of stock might be offered a substantially higher price than that offered to the general public.[106] As with coercive or front-loaded offers, most jurisdictions (including Hong Kong) prohibit this type of offer because of the potential for unfair dealing and a distortion of the marketplace, as well as the sense that identical shares of a company should sell for identical prices.[107] Ironically, in Hong Kong controlling shareholders may have the most to worry about in this regard if political influence is used to coerce the sale of control blocks at a discount from the market price.[108] In any case, keeping the unequal offer quiet until after consummation is usually important since, otherwise, all shareholders will try to hold out for the higher price. Well-enforced disclosure rules thus substantially impede the effectiveness of these offers.

Creeping control acquisitions depend even more on the effectiveness of enforcement of disclosure. An acquirer pursuing a creeping control acquisition simply accumulates a control block over time by purchasing the stock on the market, without disclosing an intent to acquire the target. This generally allows the acquirer to purchase the target at a cheaper price since tender offers virtually always require an above-market price to succeed. More importantly, it does not alert the target company or other potential acquirers and thus prevents early implementation of defenses and hinders competitive bidding or the development of an auction.[109] Whether

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106. These offers have also been used in many cases to induce the board of directors or management of the target corporation to go along with the deal by paying a higher price for the shares or options they hold. This creates a conflict of interest with the rights of other shareholders.

107. Academic opinion is somewhat more divided, as some scholars argue that unequal offers simply allow controlling shareholders to retain a control premium rather than dividing it with minority shareholders (who they argue get a windfall when their shares, which do not include control of the corporation, are valued equally with a block of shares that does deliver control).

108. This may already have happened to the Swire group, which reportedly was forced to sell a 25% stake of Cathay Pacific and a 35.9% stake of Dragonair to China National Aviation Corporation at a discount of 15% from Cathay's market price and an estimated 33% of Dragonair's value if publicly traded. *See* THE ECONOMIST, *supra* note 72, at 65.

109. This is usually very helpful to an acquirer since defensive tactics and other bidders drive up cost of acquisition as well as the risk. Since the first acquirer has often expended large amounts of money locating the acquisition opportunity, costs which later acquirers free-ride on, premature disclosure can sometimes halt takeover efforts.

shareholders receive a fair price is doubtful, however, since the prices of targets almost always increase when a takeover is announced or even suspected.[110]

Market inefficiency also results if targets are sold to less efficient acquirers.[111] Non-disclosure of large holdings also increases inefficiency by reducing the ability of acquirers to select appropriate targets.[112] Currently, the Code addresses these concerns by requiring disclosure of holdings when certain thresholds are crossed and a public tender offer once 35% of a corporation has been acquired.[113]

Creeping control acquisitions could become increasingly desirable tactics in Hong Kong because "the corporate model favored by Chinese companies is so complex, with multiple layers and various offshore entities as buffers, that it is often hard to determine the real ownership."[114] This may make a creeping acquisition the most viable method when these firms are targets, since market purchases do not require tracing the actual owners. Multiple layers and buffers can also impede a conventional acquisition, giving the target time to take defensive steps including the use of connections or other forms of corruption. Defensive measures are also less of a problem when simply accumulating shares so long as the size of the acquirer's holding is not prematurely disclosed. Persons or firms operating in Hong Kong may further prefer creeping acquisitions if internal or external politics cause them to hide their activities and holdings. In light of PRC concerns about the sale of firms in certain industries to foreign acquirers, such parties could also find quiet acquisitions useful.

Another consideration is that the effect of any of these tactics increases when combined with others. For instance, an acquirer might begin with a creeping control acquisition to accumulate as large a stake as possible before making a front-loaded public offer for the firm. This would make the front-loaded offer even more coercive since the transaction would appear inevitable and possibly allow the acquirer to set a lower price than

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110. To some extent, this question implicates the efficient capital markets hypothesis, in that if the stock is already trading at its true value, then selling shareholders have nothing to complain about, especially since any value created by the takeover attempt is created by the acquirer.

111. Under fair and competitive conditions the potential acquirer that derives the most value from the target or can use its resources most efficiently is generally willing to pay the most.

112. Without accurate ownership information, such acquirers may waste effort and resources on targets for which no realistic possibility of success exists due to large management or single controlling family stock holdings (a common ownership structure for Hong Kong firms). Fear of such waste can overly deter takeover activity since the expense of even an unsuccessful attempt can be extremely high.

113. HONG KONG CODE ON TAKEOVERS AND MERGERS, §33.

114. Einhorn, *supra* note 39, at 32.

otherwise necessary or to finish with an unequal offer because fewer additional shares would be needed. The risk to the acquirer would also be lessened because a large enough holding would deter other bidders and because a lower overall price might result if substantial target shares are acquired at the pre-tender offer price.

The corollary to the above possibilities is that if disfavored acquisition tactics come back into play, currently disfavored defensive tactics would likely re-emerge as well. Well-connected firms might feel comfortable simply saying no to takeover bids and refusing to submit the offer to shareholders for a vote. This would be especially possible for firms in such areas as telecommunications or infrastructure that the PRC has taken a special interest in.[115] The usual justification offered by directors in such circumstances is that the proposed offer is either insufficient or an attempt to purchase the firm for less than its full worth. Given the concerns already expressed by the PRC about the sale of state assets to foreigners at bargain prices,[116] this argument could attract considerable political support.

Other defensive tactics, such as asset lockups, issuance of authorized but unissued stock, or especially generous golden parachutes triggered by a takeover are also possible, but difficult, since they require more time to implement and the offensive tactics discussed above substantially decrease the time available to targets. These defenses may still be used as "shark repellent" to protect favored transactions from interference by other bidders. Similarly, to the extent that the independence of the judiciary decreases, litigation and "poison pill" or "shareholders' rights" plans are less likely to play major roles since the effectiveness of either depends on a judicial system that produces consistent and enforceable results.

IV. CONCLUSION: PRESERVING THE HONG KONG MERGER AND ACQUISITIONS ENVIRONMENT

Given the above concerns, a comprehensive review of the Code's provisions with an aim to enhancing its enforcement mechanisms should be undertaken in order to maintain the quality and efficiency of the Hong Kong merger and acquisitions environment. However, many parties do not perceive a need for such efforts or even agree that market efficiency is a

115. *Supra* note 98.

116. Lai, *supra* note 56, at 3.

desirable goal. Well-connected firms and individuals for instance, might benefit in the short term from the Code's erosion, although in the long run the adverse effect of lost investor confidence would probably overwhelm the short term advantages. Commentators have also noted that any sort of reform that attempts to implement practices modeled after those in used in the United States or Britain has met with substantial local opposition.[117] As one explains, "the issue of Chinese succession plays out against a backdrop of fierce squabbling between local brokers, who see reform as a threat to their survival, and foreign brokers, who want more Western practices to prevail. Many observers fear that the local firms will ally with Chinese officials against the Western financial houses and thwart any further reform."[118]

Aside from the immediate economic issues, the difficulties in maintaining effective regulation may stem partly from the cultural change that the return to Chinese sovereignty is bringing. This has its roots in the control that the British colonial government and powerful British trading houses exerted over local business practices since the middle of the nineteenth century.[119] The degree of economic dominance of British firms through at least 1976 made regulating their activities of primary importance. Thus, methods designed for effectiveness with respect to these firms were implemented.[120] It is not surprising therefore that the existing scheme of regulation is patterned after the methods by which these transactions have historically been regulated in Britain and assumes to some degree shared cultural values and norms that encourage compliance and make sanctions effective.

History suggests though, that Chinese culture has traditionally embraced different values and norms and, in particular, has long emphasized a clearly defined social structure that imposes strict or authoritarian control upon its members.[121] These social control methods

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117. *See* Mark Sharp, *Fresh Voice in Legco Needed*, S. CHINA MORNING POST, Mar. 8, 1998, at 2 (noting that the Securities and Futures Commission has discussed, but is "expecting a tough time devising", a code of conduct for merger and acquisitions professionals).

118. Clifford, *supra* note 7, at 42.

119. Katharyne Mitchell, *Flexible Circulation in the Pacific Rim: Capitalisms in Cultural Context*, ECON. GEOGRAPHY, Oct. 1995, at 364.

120. *See id.*

121. Anne Thurston, *A Society at the Crossroads; Chinese Society Faces Change in Values with Economic Growth*, CHINA BUS. REV., May 1994, at 16 (explaining that "Chinese values, both Confucian and communist, have been fundamentally based on a correct ordering and hierarchy of human relations"); Peter Seidlitz and David Murphy, *Business Ethics Focus of Mainland Conference*, S. CHINA MORNING POST, Apr. 13, 1997, at 3 (noting that China has been "strictly authoritarian" before and during rule by the Communist Party).

differ markedly from the British system which emphasizes individual self-regulation and make it likely that methods that attain an optimal level of deterrence in one system would not have the same effect in the other.[122] Because Chinese firms are superceding British and Western firms in market capitalization and local importance,[123] the dominant players in the Hong Kong business environment are regulated by rules that are not culturally relevant and result in under-deterrence.[124]

Some historians also argue that throughout China's history the end of each dynasty brought with it a period of chaos and disorder where social control systems collapsed and individuals acted without constraint to maximize their personal benefit before a new government reimposed order and the chance for rapid social mobility disappeared again.[125] In other words, "as the dynasty slides unpredictably toward its end, its legitimacy sapped and its control slipping, [citizens] grab what they can . . . before chaos progresses to the point where nothing is possible or before order is restored and opportunities vanish."[126] Arguably such an "end of the dynasty" period is occurring or just ending in China and helps explain the rapid rise in corruption.[127] Under this scenario, abuse of the existing Hong Kong merger and acquisition regulatory system by individuals able to do

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122. *See* Richard Priem, et al., *Moral Judgment and Values in a Developed and a Developing Nation: a Comparative Analysis*, 17 J. BUS. ETHICS (1998) (noting that comparative studies generally find similar ethical attitudes among developed Western countries but some differences when developed Western and developed Asian countries are compared). *See also* studies cited by Lisa Pelled and Katherine Xin, *Work Values and Their Human Resource Management Implications: a Theoretical Comparison of China, Mexico and the United States*, 6 J. APPLIED MGMT. STUD., 185-198 (1997) (suggesting "that national culture and business environment are two major forces in shaping the formation of work values in organizations.")

123. Mitchell, *supra* note 119, at 364 (explaining that "by 1986, the rapid rise of large, multicompany Chinese businesses and the exodus of many British businesses transformed the economic profile of Hong Kong").

124. *See* studies cited by Peter Antoniou and Katherine Whitman, *Understanding Chinese Interpersonal Norms and Effective Management of Sino-western Joint Ventures*, 6 MULTINATIONAL BUS. REV., 53, 53-62 (1998), concluding that "personal value systems have an important impact on actual decision making," and that "values influence corporate strategy." *See also* Hanke, *supra* note 84 (arguing that the reduced likelihood of punishment increases corruption).

125. Thurston, *supra* note 121.

126. *See id.*

127. Thurston, *supra* note 121, at 16 (noting that "some Chinese, particularly in the South, assert that the luan that Western analysts posit as one of several possibilities following the death of Deng has already begun"); Louise de Rosario, *Risky Business*, FAR E. ECON. REV., Jan. 26, 1995, at 21 (quoting an American attorney arguing that "there has been a very extensive breakdown in social order within Chinese enterprises").

so would be expected.[128]

The question of what can or should be done to maintain effective regulation then arises. One of the strongest options available, aside from continuing with the system as it is and accepting decreased efficiency and potential abuses, is to review and update the Code and perhaps enact all or sections of it into mandatory, enforceable laws. To this end, enacting disclosure requirements focused on providing information to stockholders and potential acquirers, control thresholds that trigger mandatory equal offers, prohibitions on defensive tactics, and minimum periods that an offer must remain open would be good places to start.[129] While the effectiveness of such measures would be affected by the concerns discussed above regarding corruption, the rule of law and the independence of the judiciary, doing so would at least give regulation and fair play a fighting chance. Non-compliance would be more obvious, which could increase disincentives for political interference and corruption.[130] Creating enforceable laws and penalties would also bring the regulatory system into closer accord with Chinese culture and regulatory norms for the region generally, thereby increasing the likelihood that effective regulation would continue.

Some evidence of the efficacy of this solution is provided by Singapore's approach to regulation of mergers and acquisitions. Like Hong Kong, Singapore initially adopted a regime based largely on the London City Code, but "decided that the pure self-regulatory system in operation in London would not work in Singapore" and so "it was deemed desirable to give the Singapore Code on Take-overs and Mergers statutory backing and some statutory teeth."[131] Admittedly, the situation in Singapore is very different from Hong Kong. Singapore enjoys substantially less corruption, a strong legal system, and does not have a powerful nation reasserting sovereignty and influencing its internal processes. Yet substantial similarities also exist, such as a mixture of Western and Chinese cultures

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128. Several studies have found that firms operating in highly competitive environments, with scarce resources and declining or uncertain profitability are more likely to engage in illegal behavior. *See* Priem, *supra* note 122.

129. Such as General Principles 2 through 5, and Rules 2, 10, 12, 13, 23 and 24 of the Hong Kong Code on Takeovers and Mergers.

130. This would occur both because of higher expectations regarding appropriate behavior and because parties would have a better incentive to monitor and take action to enforce compliance by opposing parties.

131. FFRENCH, *supra* note 15, at 132.

and dependence on foreign investment and economic efficiency.[132] The need for foreign investment alone may sufficiently counterbalance political pressures if officials perceive that losses from firms exiting outweigh gains from corrupt dealing. This is a strong possibility; the consensus of most observers is that "Hong Kong appears too important for any set of leaders to wish it serious or long term harm".[133] Moreover, many of the sort of abuses feared actually took place in Singapore prior to enactment of legislation and have largely disappeared in its wake.[134] These similarities suggest that implementing laws to enforce portions of the Code could provide greater compliance and efficiency.

In sum, the increase in PRC firms operating in Hong Kong, closer ties to the PRC, and growing perception that non-compliance is beneficial, place a tremendous amount of stress upon the current merger and acquisition regulatory system. Coupled with the substantially different cultural values underlying the Code in its current form, the eventual result may be widespread non-compliance and corresponding changes in offensive and defensive tactics by firms operating in the region. If this occurs, the Hong Kong market for corporate control could become substantially less efficient as uncertainty and risk make it more costly for firms to raise capital to finance acquisitions and corruption and/or inefficient regulation create deadweight losses.

Overall, the opportunities for merger and acquisition activity in Hong Kong are constantly increasing. In the long run though, the prospects for the continued development of Hong Kong's merger and acquisition environment parallel those of the rest of China in that sustainable growth will require effective rules and a reliable and predictable legal system. Acting now to preserve these protections in Hong Kong can only benefit the city and the industry.

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132. *See* Gerald Singham and Young Whee Choo, *Major Legal Issues: Singapore*, INT'L BUS. ACQUISITIONS, 1996, at 241 ("Singapore has always encouraged foreign investments; in fact, the backbone of the Singapore economy is very much the strength of multinationals."); Anthony Neoh, *Hong Kong's Future: The View of a Hong Kong Lawyer*, CAL. W. INT'L L. J., 1992 (explaining Hong Kong's "need to court foreign capital").

133. Hamlin, *supra* note 74, at 32.

134. FFRENCH, *supra* note 15, at 131-2.