8

Control Transactions

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8.1 Regulatory Problems in Control Transactions

In this chapter we consider the legal strategies for addressing the problems which arise when a person (the acquirer) attempts, through offers to the company's shareholders, to acquire sufficient voting shares in a company to give it control of that company.

8.1.1 Control transactions

The core "control transaction" in this chapter is one between a third party (the acquirer)[1] and the company's shareholders. Of course, control may also shift as a result of a transaction between the *company* and its shareholders or the investing public (as when a company issues or re-purchases shares or engages in a statutory merger). However, the latter type of transactions can be analyzed in the same manner as other corporate decisions, a task we have undertaken in Chapter 7. The absence of a corporate decision and the presence of a new actor, in the shape of the acquirer, give the agency problems of control transactions a special character which warrants separate treatment.[2]

Admittedly, in terms of end result, there may not be much difference between a statutory merger[3] and a takeover bid where the successful bidder squeezes out the non-accepting minority. Yet, in terms of the legal techniques used to effect the control shift, there is a chasm between the two mechanisms. A merger involves corporate decisions, usually by both shareholders and the board,[4] and often by all companies involved. Control transactions, by contrast, are effected by private contract between the acquirer and the shareholders individually. Nevertheless, at least in friendly acquisitions, the acquirer often has a free choice whether to structure its bid as a contractual offer or as a merger proposal. This creates the regulatory question of whether control transactions should be regulated so as to mimic the results of statutory merger regulation or instead be treated as presenting distinct regulatory issues.[5]

[1] Of course, the acquirer may, and typically will, already be a shareholder of the target company, but it need not be and the relevant rules (other than shareholding disclosure rules) do not turn on whether it is or not. The bidder may also be or contain the existing management of the target company (as in a management buy-out (MBO)). This situation generates significant agency problems for the shareholders of the target company which we address below.

[2] The special character of control transactions is also reflected in the increasing number of jurisdictions which have adopted sets of rules, separate from their general company laws, to regulate them.

[3] See Chapter 7.4.

[4] Where the merger is adapted to function as a post-bid squeeze-out technique, the shareholder vote may be dispensed with. See Section 8.3.5.

[5] If the choice is to regulate control transactions differently, the converse question then arises. Should control transaction regulation be added to merger regulation in order to prevent transactional arbitrage? In the UK and countries which have followed its lead, control transaction rules are extended, in so far as is appropriate, to supplement regulation of mergers. (The Panel on Takeovers

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Control transactions may be structured in a variety of ways: private contracts with a single or a small number of important shareholders ("sale of control"); purchases of shares on the market; or a general and public offer to all the shareholders of the target company.[6] The public offer may be either "friendly" (i.e. supported by the management of the target company) or "hostile" (i.e. made over the heads of target management to the shareholders of the target).[7]

Of the three acquisition methods, the second and third are clearly facilitated if the target's shares are traded on a public market. For this reason, companies with publicly traded shares are at the center of attention in this chapter. In fact, legislation specific to control transactions is usually (though not always) confined to companies whose securities are traded on public markets (or some sub-set of these, such as the top-tier markets).[8] Not only are hostile bids difficult to organize other than in relation to publicly traded companies, but also the shareholders' agency and coordination problems are less pronounced in companies with small numbers of shareholders. Nevertheless, control transactions are not logically confined to public companies and we will also make some reference to non-traded companies. In jurisdictions which rely on general corporate standards, such as fiduciary duties, rather than rules specific to control transactions, to regulate the behavior of target management or the target's controlling shareholders, the application of these standards to the managements and shareholders of non-traded companies raises no difficult boundary questions.[9]

The global takeover market has steadily grown over the past decades, with the only exceptions being after the 2001 Dotcom bubble burst and during the 2008/9 financial crisis.[10] The takeover market now appears to have recovered from its most recent crisis.[11] Traditionally, the U.S. and the UK have the most active takeover markets, while takeovers are rarer in continental Europe, emerging markets, and in Japan. Empirical studies show that takeovers are usually profitable for the target shareholders,[12] whilst the share price of the bidder is frequently unaffected by the

and Mergers, The Takeover Code (11th edn., 2013) § A3(b) and Appendix 7—hereafter "Takeover Code"). But in most jurisdictions the regulation of takeovers is confined to control shifts. Thus, Art. 2(1)(a) Directive of the European Parliament and of the Council on Takeover Bids, 2004/25/EC, 2004 O.J. (L 142) 12 (hereafter "Takeover Directive") excludes statutory mergers.

[6] Whether these three acquisition strategies give rise to the same regulatory problems is subject of considerable debate. See e.g. note 144.

[7] Of course, the board's decision whether to recommend an offer, either at the outset or during the course of an initially hostile offer, will often be influenced by its estimate of the bidder's chances of succeeding with a hostile offer. And while it may be difficult to characterize a particular bid as "friendly" or "hostile," the question of whether a particular system of rules facilitates hostile bids is of enormous importance. See Section 8.2.1.

[8] Thus the Takeover Directive applies only to companies whose securities are traded on a "regulated market" (Art. 1(1)). In contrast, however, the UK Takeover Code applies to all companies which may offer their shares to the public and even to closely held companies where there has been something analogous to a public market in the private company's shares (Takeover Code, § A3(a)).

[9] See Section 8.4.1 for a discussion of U.S. rules on sales of shares by controlling shareholders to looters.

[10] For recent analyses, see Marina Martynova and Luc Renneboog, *The Performance of the European Market for Corporate Control: Evidence from the Fifth Takeover Wave*, 17 European Financial Management 208 (2011); Marccus Partners, External Study on the application of the Directive on takeover bids, section IV (2012).

[11] Arash Massoudi and Ed Hammond, *Hostile Bids Reach 14-Year High*, Financial Times, 9 June 2014, at 3.

[12] Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale Journal on Regulation 119, 122 (1992); Marina Martynova and Luc Renneboog, *A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?*, 32 Journal of Banking & Finance 2148, 2153 (2008); Klaus J. Hopt, *Takeover Defenses in Europe: A Comparative, Theoretical and Policy Analysis*, 20 Columbia Journal of European Law 249, 252 (2014).

bid or may even suffer.[13] Overall, however, takeovers appear to create value for both groups taken together.[14] Nevertheless, judged solely from the bidder's perspective, many takeovers turn out to have been an economic misjudgment in retrospect. This raises the question of why takeovers happen in the first place.[15] That is not an issue which control transaction rules tend to address, at least not directly.[16] With due exceptions, bidder management and shareholder relations are usually left to general corporate governance rules.[17] Nevertheless, skepticism about or enthusiasm for takeover bids is reflected in takeover rules, and especially in the extent to which they facilitate hostile bids.

8.1.2 Agency and coordination issues

Takeover regulation worldwide seeks to address two main issues: agency problems, predominantly within the target company, and coordination problems among the target shareholders. The specific shape of these problems largely depends on whether the target company is controlled by a blockholder or widely held; and takeover regulation usually seeks to reflect these differences by responding to the *typical* or *prevailing* standard of ownership concentration in the jurisdiction—knowing, of course, that firms of all different shades of concentration exist in each of our jurisdictions.

8.1.2.1 Agency conflicts

Consider agency conflicts first. Where there are no controlling shareholders in the target company, the main focus is on the first agency relationship, that is, the relationship between the board and the shareholders as a class. Prior to the offer *de facto* control of the company was probably in the hands of the target board, so that, following a takeover, control shifts from the board of the target to the acquirer. Therefore, there is a disjunction between the parties to the dealings which bring about the transfer of control (acquirer and target shareholders) and the parties to the control shift itself (acquirer and target board).

It is precisely this disjunction which generates the agency issues which need to be addressed. The control transaction may be wealth-enhancing from the target shareholders' point of view but threaten the jobs and perquisites of the existing senior management. The incumbent management of the target may thus have an incentive to block such transfers by adopting a range of different "defensive measures." They may seek to make the target less attractive to a potential bidder or to prevent the offer being

[13] Jarrad Harford, Mark Humphery-Jenner, and Ronan Powell, *The Sources of Value Destruction in Acquisitions by Entrenched Managers*, 106 Journal of Financial Economics 247 (2012). See, with further references, Klaus J. Hopt, *European Takeover Reform of 2012/2013—Time to Re-examine the Mandatory Bid*, 15 European Business Organization Law Review 143, 150 (2014).

[14] B. Espen Eckbo, *Corporate Takeovers and Economic Efficiency*, 6 Annual Review of Financial Economics 51, 67 (2014). See also Martynova and Renneboog, note 12, at 2164.

[15] A number of explanations are usually put forward: first, managers may be over-optimistic, underestimating the overall costs, the likelihood of success, and the concessions that need to be made during the bidding process; secondly, the bidder management may deliberately enter into an unprofitable takeover for opportunistic reasons ("empire building"); and thirdly, the transaction may be beneficial for the entire group instead of the single bidder company. See also Hopt, note 13, at 150.

[16] Recent research suggests that a requirement of shareholder consent at the bidding company may help mitigate these problems. See Marco Becht, Andrea Polo, and Stefano Rossi, *Does Mandatory Shareholder Voting Prevent Bad Acquisitions?*, 29 Review of Financial Studies 3035 (2016).

[17] See Chapter 7.6.

put to the shareholders. These steps may take a myriad of forms but the main categories are: i) placing a block of the target's shares in the hands of persons not likely to accept a hostile bid; ii) structuring the rights of the shareholders and creditors, for example, through poison pills; and iii) placing strategic assets outside the reach of a successful bidder.

Alternatively, the transaction may not be wealth-enhancing from the shareholders' point of view but the incumbent management may have an incentive to promote it to the shareholders, because the management stands to gain from the proposed control shift, either by reaping significant compensation for loss of office or by being part of the bidding consortium. Incumbent management may use their influence with the shareholders and their knowledge of the company to "sell" the offer to its addressees or, in the case of competing bids, to favor one bidder over another.

Target firms with a controlling shareholder are not exposed to this managerial agency cost. Regulation needs to address, however, the agency relationship between the controller and the other shareholders of the target. The controlling shareholder may seek to obtain more than its proportionate share of the current value of the company or even impound into the sale price the value of the new controller's future opportunistic treatment of the non-controlling shareholders. This is particularly so where the target, upon acquisition, will become a member of a group of companies where business opportunities, which the target has been able to exploit in the past, may be allocated to other group members. The law can address this problem by focusing on the existing controlling shareholder's decision to sell, on the terms upon which the acquirer obtains the controlling block, or upon the subsequent conduct of the affairs of the target by the new controller. In the last case, reliance will be placed on the general legal strategies for constraining controlling shareholders, including group law.[18] The first and second cases point towards legal strategies specifically addressing the control transaction, though these may take a wide variety of forms, up to and including an exit right for the minority upon a change of control, via a mandatory bid requirement.[19]

By contrast, takeover rules do not often address the agency problems which arise as between the shareholders of the *acquiring* company and their board in relation to the decision to acquire the target; and we shall follow that lead in this chapter. This issue is but an example of the general agency problems existing between shareholders (and creditors) and boards in relation to setting the corporate strategy, which have been fully analyzed in earlier chapters.[20] However, it is central to this chapter to consider the extent to which regulation purportedly designed to address the agency and coordination costs of *target* shareholders impacts upon the incentives for potential bidders to put forward an offer.

8.1.2.2 Coordination problems

The rules governing control transactions need also to deal with the coordination problems of the target shareholders. In particular, the acquirer may seek to induce dispersed shareholders of the target to accept an offer which is less than optimal. There are a number of ways in which this can be done,[21] but in essence they rely on information asymmetry, undue pressure to accept the bid, or unequal treatment of the target's

[18] See Chapter 6.2.5.3. [19] See Section 8.3.4.
[20] See Chapters 3, 5, and 7 (and especially Section 7.6). [21] See Section 8.3.

shareholders. Where the target company is controlled by a blockholder, the same problem arises for the remaining shareholders, possibly as against acquirer and controlling shareholder combined.

8.1.2.3 Agency problems of non-shareholders

Whatever the structure of the target company's shareholding, agency issues will also arise between the acquirer and *non-shareholders*, especially employees. Indeed, some have argued that a substantial proportion of the gains to acquirers from takeovers are the result of wealth transfers from non-shareholder groups, especially the employees of the target.[22]

The responses of takeover regulation to this issue can be put, broadly, into one of three classes. First, those systems which allocate to the shareholders of the target the exclusive power to approve the offer find it difficult to fit into that structure a significant mechanism for the protection of non-shareholder interests, other than via disclosure of information.[23] This strategy is heavily adopted by the Takeover Directive, but the disclosure obligation sits in a vacuum, dependent for its effectiveness upon rules and institutions existing outside corporate law. In some jurisdictions such structures—usually some form of works council—do exist and may be built into the takeover process by national legislation. The recent takeover law reform in France has strengthened information rights for target employees to the extent that the procedure may severely complicate the mechanics of the bid altogether.[24] Recent changes to the UK Code improved the disclosure, monitoring, and enforcement by the Panel of takeover promises (so-called "post-offer undertakings") that the bidder (or, exceptionally, the target) makes in the course of a bid and which are directed at non-shareholder concerns.[25]

Where, however, the board is given a significant role in the takeover process, a second pattern can be discerned, which is to regard the survival of target management as a proxy for the furtherance of the interests of non-shareholder groups. Thus, in the U.S., one popular form of state antitakeover statute (the so-called "constituency statute") expands the range of interests beyond the shareholders' which management is entitled (but not bound) to take into account when responding to a takeover bid.[26] It is doubtful, however, whether, by itself, relieving directors of liability to the shareholders if they act to promote non-shareholder interests encourages anything more than self-interested behavior on the part of the target board. The greater the range of interests which directors are entitled to take into account when exercising their discretion, the more difficult it will be to demonstrate in any particular case that the standard has been breached. If this is a correct analysis, non-shareholder constituencies will benefit from

[22] Margaret M. Blair, Ownership and Control (1995); Andrei Shleifer and Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in Corporate Takeovers: Causes and Consequences 33 (Alan J. Auerbach ed., 1988).

[23] Of course, non-shareholder interests may be protected through mechanisms existing outside company law which deal with some of the possible consequences of a control shift, e.g. mandatory consultation over lay-offs. See Chapter 7.4.3.2.

[24] The Loi "Florange" No. 2014-384 of 29 March 2014 requires consultation over the bid itself between the CEO of the target and the works council (Code du travail, Arts. L. 2323-21 to L. 2323-24). The board of directors cannot issue a recommendation before the works council does, which may significantly slow down the process and even discourage takeover bids.

[25] New Rules 19.7 and 19.8. The background is non-compliance with such promises in the past.

[26] See e.g. § 717(b) New York Business Corporation Law. To the extent it applies, section 172 Companies Act 2006 (UK) is another good example.

such rules only to the extent that their interests are aligned with those of the target board.[27]

The third pattern involves giving non-shareholders decision rights, though in practice jurisdictions only deploy this strategy in relation to employee interests. In those jurisdictions (notably Germany) in which company law is used in a significant way to regulate the process of contracting for labor,[28] the presence of employee representatives on the supervisory board and the relative insulation of the board from the direct influence of the shareholders may enable those representatives to have a significant input into takeover-related decisions, up to the point where control shifts are hard to achieve without the consent of the employee representatives.[29]

Creditors, as well as employees, may stand to lose out as a result of changes in the company's risk profile post-bid, perhaps arising from the leveraged nature of the bid. Those most at risk, the long-term lenders, are well placed to protect themselves by contractual provisions, such as "event risk" covenants in loans.[30] Such protections may not always be fully protective of the creditors, but adopting sub-optimal contractual protection is normally part of the commercial bargain. Consequently, the agency costs of creditors are not usually addressed in control-shift rules.[31]

8.1.2.4 The sources of rules governing control transactions

In principle, regulation of control transactions can be addressed through rules specific to control shifts or by the application of the established principles of corporate and securities law, albeit in a new context. In practice, this question is largely conterminous with the question of whether these rules are made by legislators or courts. All our jurisdictions utilize to some degree both types of approach, but the balance between them can vary considerably. Towards one end of the spectrum stands Delaware. Here the courts have played a major role by adapting the general fiduciary standards applying to boards and controlling shareholders to the control shift context.[32] Takeover-specific law, whether in the form of federal (Williams Act)[33] or state legislation (rules governing access to the short-form, squeeze-out merger),[34] plays a subordinate role.

[27] See also Mark J. Roe, Political Determinants of Corporate Governance 45 (2002) (employee influence is indirect and weak, constituency statutes being made by and for managers).

[28] See Chapter 4.2.1.

[29] German law *de facto* opts out from the Takeover Directive's board neutrality rule by allowing defensive measures if these have been approved by the supervisory board which is codetermined in the large corporations.

[30] William W. Bratton, *Bond Covenants and Creditor Protection*, 7 European Business Organization Law Review 39, especially at 58–62 (2006).

[31] It is sometimes difficult to distinguish covenants whose aim is to protect the lender and those which aim to protect target management ("poison debt"); in fact, both groups may have an interest in inserting provisions which make debt repayable upon a change of control. However, this point relates to the agency costs of the shareholders, not the creditors.

[32] It has been argued that the litigation focus of U.S. takeover regulation made it easier for a pro-management approach to emerge because, on the one hand, case law precedents are relatively free from interest-group influence and, on the other, the courts can decide only the cases which come before them and management (and their lawyers) are in a good position to control the flow of litigation and appear as repeat players before the courts. See John Armour and David Skeel, *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergences of U.S. and U.K. Takeover Regulation*, 95 Georgetown Law Journal 1727, 1793 (2007).

[33] 1968, 82 Stat. 454, codified at 15 U.S.C. §§ 78m(d)–(e) and 78n(d)–(f), adding new §§ 13(d), 13(e), and 14(d)–(f) to the Securities Exchange Act of 1934.

[34] Section 8.3.5.

By contrast, in the EU rules specific to control shifts are more important (though not to the complete exclusion of general rules of corporate and securities law). Thus, the Takeover Directive lays down an extensive set of rules which are confined to control shifts. Similarly, the regulation of control transfers under Brazilian law is also primarily based on specific rules.[35] Japan sits somewhat between these two models.[36] It has legislation specific to control shifts,[37] but, on the central issue of the allocation of decision rights over the offer, court-developed general standards applying to directors' decisions are still central.[38]

Where regulation of control shifts is predominantly through takeover-specific rules, the rule-maker is likely to create a specialized agency to apply the rules, as mandated by the Takeover Directive.[39] This will generally be the financial markets regulator but may be a specific regulator for takeovers.[40]

8.2 Agency Problems in Control Transactions

Agency problems may arise in both widely held and controlled target corporations: the incumbent controller is the target board in the former case and the blockholder in the latter. In both cases, takeover regulation addresses the tensions between the "controller" and the (minority) shareholders. In the following, we will first predominantly look at the case of a widely held target, and subsequently address the specific differences in a target company that is controlled by a blockholder (Section 8.4).

8.2.1 The decision rights choice: Shareholders only or shareholders and board jointly

The central issue is whether the bidder is free to make and maintain an offer to the target shareholders without the consent of the incumbent management. The available solutions range from allocating the decision on the control transaction exclusively to the shareholders by depriving the management of any role in the interactions between acquirer and target shareholders, to designing the control shift decision as a joint one for incumbent management and shareholders. In the former case, the shareholders' agency problems as against the management are resolved by terminating the agency relationship for this class of decision: the principal is protected by becoming the decision-maker[41] and free transferability of shares becomes paramount. In the latter case, both management and target shareholders must consent if the control shift is to

[35] See e.g. Arts. 254-A and 257 Lei das Sociedades por Ações.

[36] On the emerging framework in Japan, see John Armour, Jack B. Jacobs, and Curtis J. Milhaupt, *The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework*, 52 Harvard International Law Journal 291, 248 ff. (2011); Hideki Kanda, *Takeover Defences and the Role of Law: A Japanese Perspective*, in Perspectives in Company Law and Financial Regulation 413 (Michel Tison et al. eds., 2009); Masaru Hayakawa, *Die Zulässigkeit von Abwehrmaßnahmen im sich entwickelnden japanischen Übernahmerecht*, in Festschrift für Klaus J. Hopt 3081 (Stefan Grundmann et al. eds., 2010).

[37] See Art. 27-2 of the Financial Instruments and Exchange Act and Section 8.3.4.

[38] Section 8.2.2—coupled in this case with non-binding guidelines issued by the government.

[39] Art. 4(1).

[40] The former is by far the more common choice within Europe but the UK and countries which follow its model usually give the supervision of takeovers to a body separate from the general financial market regulator.

[41] Typically, the shareholders determine the fate of the offer by deciding individually whether to accept the offer or not, but in some cases the shareholders' decision may be a collective one, as where the shareholders decide in a meeting whether to approve the taking of defensive measures by the

occur. The acquirer is forced to negotiate with both groups. The potential gains from the control shift may now have to be split three ways (acquirer, target shareholders, target management) and, to the extent that the benefits to management of their continuing control of the target company exceed any share of the gain from the control shift which the acquirer is able or willing to allocate to them, fewer control shifts will occur.

8.2.2 The "no frustration" rule

The UK Takeover Code embodies the former choice in a strong form. Since its inception in 1968 it has contained a "no frustration" principle addressed to the board of the target company. This provides that "during the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent, the board must not, without the approval of the shareholders in general meeting, take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits … "[42] This will affect, e.g. the issuance of new shares, the acquisition or disposal of significant assets, leveraging the capital structure or entering into substantial contracts other than in the ordinary course of business.[43] The board will, however, typically remain entitled, in fact required, to give its assessment of the bid and may search for an alternative bidder (the "white knight").[44]

The no frustration or, in EU jargon, "board neutrality" rule[45] is an effects-based rule, not one dependent on the intentions or motives of the board. Action on the part of the incumbent management which might obstruct an offer is legitimate under this rule only if the shareholders themselves have approved it, that is, have in effect rejected the offer. The no frustration rule recognizes that effective implementation of exclusive shareholder decision-making requires rules which ensure not only that shareholders are free to accept offers which are put to them, but also that offerors are free to put offers to the shareholders. In other words, the law must provide entry rules for acquirers as well as exit rules for shareholders.

The no frustration rule is not, however, imposed by the Takeover Directive; rather the choice is left to the member states. All the major continental jurisdictions make it possible for companies to avoid the "no frustration" rule (with varying degrees of flexibility).[46] Where the "no frustration" rule is not applied, the general principles of national corporate law determine the target board's freedom of action.

incumbent management or where the shareholders vote to remove a board that will not redeem a poison pill: Sections 8.2.2 and 8.2.3.

[42] Rule 21.1.

[43] See Takeover Code, Rule 21.1(b). Note that the items listed there are examples only.

[44] See e.g. Art. 9(2) and (5) Takeover Directive. Jurisdictions are generally relaxed about white knights because the decision of whether to accept an offer and, if so, which one, is still ultimately left to the shareholders.

[45] The EU-level discussion normally uses the term "board neutrality" but we prefer the term "no frustration" as more accurately indicating the scope of the rule. See Section 8.2.2.1.

[46] After the Directive was implemented across the EU, takeover laws across member states were surprisingly overall less favorable to board neutrality than they had been previously. See Paul Davies, Edmund-Philipp Schuster, and Emilie van de Walle de Ghelcke, *The Takeover Directive as a Protectionist Tool?* in Company Law and Economic Protectionism 105, 138 ff. (Ulf Bernitz and Wolf-Georg Ringe eds., 2010). Even a jurisdiction like France, which originally adopted the neutrality rule, has gone back on that choice (see Section 8.2.3.).

It is clear in both the Takeover Code and the Directive that shareholder approval means approval given during the offer period for the specific measures proposed and not a general authorization given in advance of any particular offer. A weaker form of the shareholder approval rule is to permit shareholder authorization of defensive measures in advance of a specific offer. This is a weaker form of the rule because the choice which the shareholders are making is presented to them less sharply than under a post-bid approval rule.[47] On the other hand, rendering pre-bid approval of post-bid defensive measures ineffective makes it more difficult for shareholders to commit themselves to handling future offers through board negotiation with the bidder.[48] Pre-bid shareholder approval is one way of legitimizing defensive action in Germany[49] and also in Japan. In the latter, the governmental guidelines favor pre-bid approval of defensive action "to allow the shareholders to make appropriate investment decisions."[50] However, court decisions are unclear on whether pre-bid approval will always legitimize defensive measures.[51] Given the scarcity of hostile takeovers in Brazil, the law on the legitimacy of defensive measures remains underdeveloped and, therefore, uncertain. Nevertheless, Brazil's newly created Takeover Panel, whose membership is voluntary and still small, imposes a version of the no frustration rule during a pending offer.[52]

8.2.2.1 No frustration, neutrality, passivity, and competing bids

The "no frustration" rule does not require boards to be "neutral," let alone "passive." There will remain a number of situations where the target board, consistently with the rule, may take action which may significantly influence the outcome of the offer. First, incumbent management remains free to persuade shareholders to exercise their right of choice in a particular way and, indeed, in most jurisdictions the target board is required to provide the shareholders with an opinion on the offer. This recognizes the role of the incumbent management in addressing the information asymmetry problems of the target shareholders.

[47] This point is well captured in the French terminology which refers to advance authorization as approval given "*à froid*" and authorization given after the offer as given "*à chaud*."

[48] On pre-commitment see Chapter 7.2. For the possible use of pre-bid defensive measures to this end see Section 8.2.3.

[49] Wertpapiererwerbs- und Übernahmegesetz ("WpÜG"), § 33(2). Such permission may be given for periods of up to eighteen months by resolutions requiring the approval of three-quarters of the shareholders, though the constitution of a particular company may set more demanding rules. However, approval may also be given post-bid by the supervisory board without shareholder approval (WpÜG § 33(1)), and so pre-bid approval by shareholders seems unimportant in practice. See Klaus J. Hopt, *Obstacles to Corporate Restructuring: Observations from a European and German Perspective*, in Perspectives in Company Law and Financial Regulation 373, at 373–95 (Michel Tison et al. eds., 2009).

[50] Ministry of Economy, Trade and Industry (METI) and Ministry of Justice, Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests, 27 May 2005, p. 2. These guidelines are not legally binding but seek to capture court decisions and best practice. See also Corporate Value Study Group, Takeover Defense Measures in Light of Recent Environmental Changes, 30 June 2008.

[51] As of the time of writing, there has been no court decision concerning a defensive measure based on the Guidelines accompanied by pre-bid approval. However, the Supreme Court in the *Bulldog Sauce* case upheld the issuance of warrants as a defensive measure that had been approved by the shareholders after the bid had been launched and acquirer was treated fairly in respect of its pre-bid holdings (if not in the same manner as the other shareholders of the target): Supreme Court of Japan, 7 August 2007, 61 Minshu 2215. See also Sadakazu Osaki, *The Bulldog Sauce Takeover Defense*, 10(3) Nomura Capital Markets Review 1 (2007).

[52] Código de Autorregulação de Aquisições e Fusões Art. 156, IX.

Second, the management may appeal to the competition authorities to block the bid, presumably the rationale being that this is an efficient way of keeping the public authorities informed about potential competition concerns, whilst the public interest in competitive markets must trump the private interest of shareholders in accepting the offer made to them.

Third, the rule is usually understood as a negative one, not requiring incumbent management to take positive steps to facilitate an offer to the shareholders (except in some cases where a facility has already been extended to a rival bidder). Thus, the no frustration rule does not normally require the target management to give a potential bidder access to the target's books in order to formulate its offer.[53] The first and third possibilities often give the management of the target significant negotiating power with the bidder as to the terms of the offer. This may explain why takeover premia are not significantly different in the UK from the U.S., despite the no frustration rule in the UK Code.[54]

8.2.2.2 White knights and competing bids

The no frustration rule does not prevent an incumbent management from seeking to enlarge the shareholders' choice, for example, by seeking a "white knight." Whether or not sought by the incumbent management, a competing bidder may emerge. The wealth-enhancing impact of competing bids as far as target shareholders are concerned is well established in the empirical literature. However, the cost associated with rules which facilitate competing bids is that they reduce the incentives for first offers to be made. First bidders often lose out if a competitor emerges, and in that situation the search and other costs incurred by the first bidder will be thrown away. This will discourage first bidders generally and so reduce the number of offers.[55]

More broadly, "any regulation that delays the consummation of a hostile [or even a friendly] bid … increases the likelihood of an auction by providing time for another bidder to enter the fray, upon the target's solicitation or otherwise."[56] Thus, takeover rules ostensibly aimed at other problems may have a significant impact on the chances that an alternative offer will be forthcoming. An example is rules which require the bid to remain open for a certain minimum period of time (in order that shareholders shall not be pressurized into accepting the offer before they have had a chance to evaluate it). Another is rules requiring disclosure to the market of the beneficial ownership of shareholdings above a certain size, which may give a potential competitor advance warning that an offer for a particular target company is likely to be forthcoming.[57] If a competitor does emerge, whether through the actions of the target management or not, its task is facilitated in those systems which permit acceptors to withdraw their acceptance of the first offer, unless it has been declared unconditional, either for any

[53] Certainty about the target's income generating potential may be very important for a leveraged offeror.

[54] John C. Coates IV, *M&A Break Fees: U.S. Litigation vs. UK Regulation*, in Regulation versus Litigation: Perspectives From Economics and Law 239, 255 (Daniel P. Kessler ed., 2011).

[55] Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harvard Law Review 1161 (1981). This trend is reinforced by some jurisdictions' requirement of information parity. For instance, in the UK, if the target board shares information during due diligence to a preferred bidder, it must be willing to share similar information to another bidder (although not preferred) in response to specific questions (Takeover Code, Rule 22).

[56] Romano, note 12, at 156.

[57] See Section 8.2.4.

reason or if a competing offer emerges.[58] To the same effect are rules giving competing bidders equal treatment with the first bidder as far as information is concerned.[59]

There are a number of techniques which can be used to mitigate the downside to the first bidder of rules which facilitate competing bids.[60] Where the directors of the potential target judge that it is in the shareholders' interests that a bid be made for their company and that an offer will not be forthcoming without some protection against the emergence of a competitor, the directors of the target may contract not to seek a white knight or not to cooperate with one if it emerges. However, contracting not to recommend a better competing offer is normally ruled out on fiduciary duty grounds.[61] More effective from the first offeror's point of view would be a financial commitment from the target company in the form of an "inducement fee" or "break fee," designed to compensate the first offeror for the costs incurred if it is defeated by a rival. Such fees are common in the U.S., but have recently been severely constrained in the UK due to their potential impact upon free shareholder decision-making.[62] They could be used to give a substantial advantage to the bidder preferred by the incumbent management. Finally, the first offeror could be left free to protect itself in the market by buying shares inexpensively in advance of the publication of the offer, which shares it can sell at a profit into the competitor's winning offer if its own offer is not accepted. Although pre-bid purchases of shares in the target (by the offeror) do not normally fall foul of insider dealing prohibitions,[63] rules requiring the public disclosure of share stakes and of economic interest in shares limit the opportunity to make cheap pre-bid purchases of the target's shares.[64]

Overall, in those jurisdictions which do not permit substantial inducement fees, the ability of the first bidder to protect itself against the financial consequences of a competitor's success are limited.

8.2.3 Joint decision-making

Where management is permitted unilaterally to take effective defensive measures in relation to an offer, the process of decision-making becomes in effect a joint one involving both shareholders and management on the target company's side. Unless the target board decides not to take defensive measures or to remove those already implemented, the offer is in practice incapable of acceptance by the shareholders. Perhaps the best

[58] This is the predominant rule in takeover regulations, including in the U.S. (see § 14(d)5 Securities Exchange Act and Rule 14d-7)—though not in the UK (Takeover Code, Rule 34, allowing withdrawals only more narrowly). The bidder may seek to avoid this rule by obtaining irrevocable acceptances outside the offer (and usually before it is made)—though the acceptor may choose to make the acceptance conditional upon no competing bidder emerging.

[59] See note 55 and Section 8.3.1.

[60] For further analysis see Athanasios Kouloridas, The Law and Economics of Takeovers: an Acquirer's Perspective (2008) chs. 6 and 7.

[61] *Dawson International plc v. Coats Patons plc* [1990] Butterworths Company Law Cases 560 (Court of Session).

[62] They are usually in the 2–5 percent range in the U.S. Significantly, the UK Code (rule 21.2 notes) still allows break fees (up to 1 percent) in favor of a competing bidder, where the original offer was not recommended by the target board. It also allows a 1 percent fee in favor of the first bidder, if that offer is the outcome of a formal sale process initiated by the target board. They are allowed in Germany: see Hopt, note 12, at 276.

[63] See e.g. Recital 30 to EU Market Abuse Regulation 596/2014, 2014 O.J. (L 173) 1.

[64] See, in the context of the shareholder activism debate, John C. Coffee, Jr., and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 Annals of Corporate Governance 1 (2016).

known of such measures is the "poison pill" or shareholders' rights plan, as developed in the U.S.[65] Here, the company's charter provides that the crossing by an acquirer of a relatively low threshold of ownership (typically, 10 or 20 percent) triggers rights for target shareholders to acquire shares in either the target or the acquirer on favorable terms, from which the acquirer itself is excluded.[66] The dilutive effect of the plan on the acquirer renders the acquisition of further shares in the target fruitless or impossibly expensive. The ease with which a plan can be adopted by management of potential target companies means that even companies with no apparent defense in place can adopt one in short order, so that the distinction between pre- and post-bid defensive measures becomes meaningless. It has also been considered to be a powerful legal technique, apparently putting the incumbent management in a position where they can "just say no" to a potential acquirer.[67] Where the bid is acceptable, in the board's view, it may "redeem" the pill and thus allow the takeover to go ahead. Defensive measures in the U.S. rely so heavily on poison pills that separate "antitakeover" statutes adopted by a number of states have become largely irrelevant.[68] As we will see below, the standard mode of "hostile" takeover bids shifts to the proxy contest, where the bidder seeks to replace the board with one which will redeem the pill.[69]

In France the legislature in 2006 designed a shareholder rights plan (so-called "bons Breton" or, tellingly, "bons patriotes")[70] and slotted it into the overall statutory regulation of control transactions. However, as is generally the case in Europe, the issuance of new shares requires shareholder approval. Initially, French law required that approval to be given post-bid (with a reciprocity-based exception), in compliance with the no frustration rule. However, in 2014 (under the so-called "Loi Florange")[71] the French nofrustration rule was repealed and pre-bid approval of plans made available (though requiring periodic renewal). Now, the scheme operates as a way for shareholders to commit to the incumbent management. French shareholders appear to have made little use of the possibility, arguably distrusting the management before they even know the terms of an offer.[72]

[65] Poison pills were first designed as a response to the 1980s hostile takeover wave. In many respects, they function today as a shield against contemporary activist hedge funds. Put differently, activist hedge funds may be considered, in some degree, as a market response to the dramatically increased effectiveness of defensive tactics against hostile bids resulting from poison pills.

[66] See e.g. Lucian A. Bebchuk and Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 Columbia Law Review 1168 (1999). See also, by the same authors, *On Takeover Law and Regulatory Competition*, 57 Business Lawyer 1047 (2002).

[67] "The passage of time has dulled many to the incredibly powerful and novel device that a so-called poison pill is. That device has no other purpose than to give the board issuing the rights the leverage to prevent transactions it does not favor by diluting the buying proponent's interests (even in its own corporation if the rights 'flip-over')": Strine V-C in *Hollinger Int'l v. Black*, 844 Atlantic Reporter 2d 1022, 1064–5 (2004, Del. Ch.).

[68] Emiliano Catan and Marcel Kahan, *The Law and Finance of Antitakeover Statutes*, 68 Stanford Law Review 629 (2016).

[69] See Section 8.2.3.2.

[70] See Loi No 2006-387 of 31 March 2006. Given the presence of a mandatory bid rule in France, the warrants are triggered only by a general offer and, for that reason, it was unnecessary to exclude the offeror from the rights.

[71] See Arts L. 233-32 and L. 233-33 Code de commerce, as amended by the Loi "Florange" No. 2014-384 of 29 March 2014. On this reform, see Quentin Durand, *Loi visant à reconquérir l'économie réelle: présentation des aspects relatifs aux offres publiques*, Bulletin Joly Bourse 274 (2014); Eva Mouial-Bassilana and Irina Parachkévoya, *Les apports de la loi* Florange *au droit des sociétés*, Bulletin Joly Sociétés 314 (2014); Alain Viandier, OPA, OPE, et Autres Offres Publiques, nos 2045 ff. (5th edn., 2014).

[72] Durand, note 71, at 281, n. 53.

This recent reform has brought France somewhat closer to the U.S. system, as it is now possible for the shareholders to issue warrants before a bid is launched or to authorize the board to issue them even when a bid has been launched, without further shareholder involvement. The authorized board can thus negotiate with a potential bidder and equally has discretion to trigger the warrants. Nevertheless, a number of important differences persist. First, unlike U.S. poison pills, the French warrants can only be adopted or authorized by shareholder resolution and not by the board alone. Secondly, the warrants must be issued to all the shareholders, including the acquirer's likely pre-bid shares.[73] Thirdly, the *bons Breton* can only be triggered when a genuine "takeover bid" has been launched. They will not work against creeping acquisitions. And finally, the French warrants are bid-specific. When the bid is not successful, they automatically become void.[74]

With the removal of the nofrustration rule, incumbent management may be able to take other defensive steps, either with pre-bid shareholder approval or without shareholder approval. In France as in other jurisdictions in this position the possibilities for unilateral defensive measures will depend upon the extent to which shareholder approval is required under general corporate law or the company's articles.[75] As we have seen in previous chapters,[76] the powers of centralized management are extensive in relation to the handling of the company's assets, but in many jurisdictions they are more constrained where issues of shares or securities convertible into shares are concerned, because of their dilution potential for the existing shareholders. However, defensive measures which focus on the company's capital rather than its business assets would be more attractive to incumbent management, because they are less disruptive of the underlying business and a more powerful deterrent of the acquirer.

Equally, the development of share warrants as a defensive measure in Japan was premised upon changes in general corporate law (not aimed specifically at control transactions) which expanded the board's unilateral share-issuing powers.[77] Whether it is legitimate for the board to use its powers to defeat a takeover is, of course, a separate question, but without the power, the question does not even arise. Alternatively, acquirers may be discouraged through a customized version of the mandatory bid rule. The Brazilian version of the "poison pill" originally consisted in "immutable" charter provisions imposing on acquirers of a certain percentage of the company's stock the obligation to launch a mandatory bid to all shareholders—often at a large premium over the market price specified *ex ante*. Conceived as entrenchment devices for existing blockholders holding less than a majority of the voting capital, these provisions soon became controversial and their legality was questioned.[78] Subsequent revisions to the Novo Mercado, Brazil's premium corporate governance listing segment, outlawed immutable provisions, so that a majority of shareholders can amend the charter to eliminate the mandatory bid requirement at any time.[79]

[73] Though the shares which the bidder has agreed to acquire through the bid do not count for entitlement to the warrants. See also note 70.

[74] Art. L.233-32, II, fourth alinéa Code de Commerce.

[75] See Matteo Gatti, *The Power to Decide on Takeovers: Directors or Shareholders, What Difference Does It Make?*, 20 Fordham Journal of Corporate & Financial Law 73 (2014).

[76] See especially Chapter 3.2.3 and Chapter 7.

[77] For the use of share warrants as defensive measures in Japan, see notes 50 and 51 and their accompanying text.

[78] Parecer de Orientação CVM No. 36 (2009).

[79] Novo Mercado Regulations Art. 3.1.2.

8.2.3.1 Strategies for controlling the board's powers to take defensive measures

Although the no frustration rule is not a fully fledged passivity rule, it nevertheless operates so as to put the shareholders in the driving seat as far as decision-making on the offer is concerned. The coordination problems of target shareholders as against the acquirer then become a significant concern where the no frustration principle applies. By contrast, joint decision-making strategies permit the incumbent management to negotiate on behalf of the shareholders and to take other steps in their interests, such as rejecting bids which undervalue the company. If incumbent management's decision-making power is used in the shareholders' interests, rather than to promote the self-interest of the management, it can be argued that the outcome is superior to that achieved by lodging the decision right wholly with the shareholders.[80] However, to achieve this result, a joint decision-rights strategy needs to be accompanied by one or more other strategies which constrain incumbent management discretion. There is a range of available strategies: standards, trusteeship, removal rights, and reward strategies.

8.2.3.2 Standards

Ex post scrutiny by the courts of the exercise of the veto power by management is available in principle, under the general law relating to directors' duties. The rigor of this scrutiny can vary by jurisdiction and over time. It has been argued[81] that in the 1980s the Delaware courts applied fiduciary duties to directors in such a way as to sustain refusals to redeem poison pills only where the bid was formulated abusively as against the target shareholders. Later on, court review became more accommodating of managerial interests. The starting point was adoption of the view that decisions on the fate of a bid are in principle as much a part of the management of the company, and thus within the province of the directors, as any other part of corporate strategy.[82] The shareholders' interests became paramount only if the incumbent management had reached a decision to sell control of the company or to dispose of its assets.[83] Otherwise, the decision to maintain the existing business strategy of the company by resisting a takeover was one that the board was in principle free to take, whether or not the offer would maximize shareholder wealth in the short term.[84]

In Japan as well, in the absence of shareholder approval, the governmental guidelines and court decisions anticipate that defensive action by target management will be lawful only where it enhances "corporate value" and promotes the shareholders'

[80] The attractiveness of this argument depends, of course, on (a) how easily the shareholders' coordination problems can be addressed if management is sidelined (Section 8.3) and (b) how much scope for negotiation is left to the incumbent board under the nofrustration rule (Section 8.2.2.1).

[81] Lucian Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 University of Chicago Law Review 973 at 1184–8 (2002). See also R. Gilson, *UNOCAL Fifteen Years Later (and What We Can Do About It)*, 26 Delaware Journal of Corporate Law 491 (2001).

[82] *Paramount Communications Inc. v. Time Inc.*, 571 Atlantic Reporter 2d 1140 (1989); *Unocal Corp. v. Mesa Petroleum Co.*, 493 Atlantic Reporter 2d 946 (1985); *Unitrin Inc. v. American General Corporation*, 651 Atlantic Reporter 2d 1361 (1995).

[83] *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 Atlantic Reporter 2d 173 (1986); *Paramount Communications v. QVC Network*, 637 Atlantic Reporter 2d 34 (1994).

[84] In many U.S. states the managerialist approach was adopted legislatively through "constituency statutes" which, while appearing to advance the interests of stakeholders, in particular labor and regional interests, in practice operated—and were probably intended to operate—to shield management from shareholder challenge. Romano, note 12, at 171, and Section 8.1.2.3.

interests.[85] Consequently, defensive measures not approved by the shareholders will stand a greater chance of meeting this standard if the bid is coercive, animated by greenmail, or based on information asymmetry as between acquirer and target shareholders.[86] Overall, there is little evidence in any jurisdiction that the courts are willing to scrutinize rigorously the discretion vested in management under the dual decision-making model.[87]

8.2.3.3 Removal rights

In the U.S., strong defensive measures available to target boards induced the response from acquirers, who were unwilling or unable to appease the incumbents, of relying on removal rights, that is, launching a proxy fight to seek removal of the target directors. Where the proxy fight is successful, the bidder can replace the directors with his own appointees, who will then redeem the pill. Whilst this strategy has been obstructed for a long time due to the presence of staggered boards[88] in many U.S. corporations, the more recent years have shown a trend towards "destaggering,"[89] which renders this strategy more attractive. Nevertheless, the need to remove the incumbents constrains the acquirer's freedom in relation to the timing of the offer because, in Delaware, removal is practicable only at the annual general meeting.[90]

8.2.3.4 Trusteeship

An additional strategy to constrain incumbent management discretion on takeover-related decisions is to require approval from independent directors. In Germany defensive measures proposed by the managing board need approval by the supervisory board.[91] This strategy heavily depends for its effectiveness on the ability of the supervisory board to play a genuinely independent role. This may be questionable in the case where the board is codetermined, since the employee representatives on the

[85] Defensive measures against a non-coercive bid were struck down in the *Livedoor* case: Tokyo High Court Decision on 23 March 2005, 1899 Hanrei Jiho 56.

[86] METI and MoJ Guidelines, note 50, at 4–5. For a discussion of *Livedoor* and other cases see Sôichirô Kozuka, *Recent Developments in Takeover Law: Changes in Business Practices Meet Decade-Old Rule*, 21 Zeitschrift für Japanisches Recht 5, 12–16 (2005).

[87] Thus, in Germany the managing board's power to take defensive action with the consent of the shareholders and/or the supervisory board will not relieve it of its duty to act in the best interests of the company. Whilst there is much academic discussion of what this limitation means, it is doubtful whether it prevents management entrenchment except in egregious cases. However, there is some evidence that the Delaware courts have done a better job with the standards strategy when it has been deployed to control managerial *promotion of* (rather than resistance to) control shifts. See Robert B. Thompson and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vanderbilt Law Review 113 (2004).

[88] A board is called "staggered" where a proportion only—normally one-third—of the board is up for re-election at each annual meeting. See Chapter 3.2.2.

[89] More than 60 percent of S&P 500 companies had a staggered board in 2002; by 2013, this number had declined to 12 percent. See Weili Ge, Lloyd Tanlu, and Jenny Li Zhang, *Board Destaggering: Corporate Governance Out of Focus?* Working Paper (2014), at ssrn.com.

[90] On the advantages of the bid over a proxy fight see Louis Loss, Joel Seligman, and Troy Paredes, Fundamentals of Securities Regulation 562 (6th edn., 2011).

[91] The managing board may seek the advance approval of the shareholders for defensive measures but then any exercise of the power must be approved by the supervisory board (WpÜG § 33(2)) or it may take defensive measures simply with the approval of the supervisory board (WpÜG § 33(1), last sentence). Only the last-minute amendments to § 33 in the legislative process explain this oddity. In practice, there seems little value to the management in obtaining prior approval of the shareholders.

supervisory board will typically favor the management's rather than the shareholders' standpoint.[92] Equally, board decisions in the U.S. to redeem or not a poison pill are typically taken by the independent members of the board. Here there are no complications arising from codetermination but the independence of the non-executives is still an open issue.

The U.S. alternative to negotiating with the incumbents is, in reality, often a combination of removal and trusteeship strategies, since overwhelmingly the boards of U.S. public companies are composed of independent directors. That these combined strategies may not work out as the acquirer intended is shown by the *Airgas* case. Airgas was subject to a hostile bid by competitor Air Products, but the former's board, relying on its poison pill, rejected the bid as too low.[93] Air Products thus initiated a proxy fight and successfully installed three new independent directors in Airgas' board. These newly elected directors, after taking independent advice, surprised the market by sharing the other directors' view that the bid indeed undervalued Airgas, and became the most vociferous opponents of Air Products' offer. This ultimately credible result seems to have emerged from the combination of two strategies discussed here: the removal strategy—replacing incumbent directors—and the trusteeship strategy—installing genuinely independent directors, not just representatives of the bidder, plus the use of outside advice.[94]

Another variant of, or addition to, the trusteeship strategy is the obligation on the board to seek "independent advice" or a "fairness opinion" from outside the company—something which was also a factor in the *Airgas* case.[95] This is required in the UK and France.[96] In the U.S., fairness opinions are routinely obtained by the target board, as a consequence of the Delaware case-law, most importantly *Smith v. Van Gorkom*.[97] More recently, both the Delaware courts and the SEC have developed detailed guidelines on what counts as an "independent" fairness opinion.[98]

8.2.3.5 Reward strategy

Under this strategy the self-interest of the incumbent management in retaining their jobs is replaced by self-interest in obtaining a financial reward which is dependent upon surrendering control of the company to the acquirer.[99] This may arise because: (i) rewards under general incentive remuneration schemes for managers are triggered upon a transfer of control;[100] (ii) payments can be claimed under the

[92] See Hopt, note 49, at III.A.b.

[93] For a fuller description, see *Air Products and Chemicals, Inc. v. Airgas, Inc.*, 16 Atlantic Reporter 3d 48 (Del. Ch. 2011).

[94] See Edward B. Rock, *Institutional Investors in Corporate Governance*, in Oxford Handbook of Corporate Law and Governance (Jeffrey N. Gordon and Wolf-Georg Ringe eds., 2017), available at <http://www.oxfordhandbooks.com/view/10.1093/oxfordhb/9780198743682.001.0001/oxfordhb-9780198743682>.

[95] Ibid.

[96] UK Takeover Code, r 3; Règlement Général de l'AMF, Book II, Title VI, chapters I and II.

[97] 488 Atlantic Reporter 2d 858 (Del. 1985).

[98] For detailed references, see David Friedman, *The Regulator in Robes: Examining the SEC and the Delaware Court of Chancery's Parallel Disclosure Regimes*, 113 Columbia Law Review 1543 (2013).

[99] Marcel Kahan and Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 University of Chicago Law Review 871 (2002); Jeffrey N. Gordon, *An American Perspective on Anti-takeover Laws in the EU: The German Example*, in Reforming Company and Takeover Law in Europe 541 (Guido Ferrarini et al. eds., 2004).

[100] E.g. because of accelerated stock options.

management's contracts of service;[101] or (iii) less often, ad hoc payments are made to the incumbent management, either by the acquirer or the target company, in connection with a successful control shift. Where such payments are available, it is argued that the reward strategy succeeds in generating powerful incentives not to invoke the poison pill or other defensive measures.[102] However, as explained below, in many legal systems it is unacceptable or unlawful to make payments of a sufficient size to amount to a significant counter-incentive for the managers, at least without the consent of the shareholders.

Thus, as we saw in Chapter 3, in the *Mannesmann* case, a payment to the CEO of a German target company after a successful takeover led to criminal charges against him for corporate waste (embezzlement). The test developed by the top criminal court for corporate waste was a tough and objective one,[103] and it has received strong criticism in the academic literature.[104] This liability can be avoided by contracting in advance for the payment of compensation for loss of office, and corporate practice has quickly adjusted, but the decision appears to have chilled the levels of contractual compensation as well. In the UK gratuitous payments as well as some contractual entitlements in connection with loss of office after a takeover require shareholder approval, in the absence of which the payments are regarded as held on trust for the shareholders who accepted the offer.[105] This remedy nicely underlines the fact that strengthening the role of incumbent management in control shifts is likely to lead to the diversion to them of part of the control premium.[106] However, the UK rules operate in the presence of the no frustration rule. Hence, the need to incentivize directors to avoid defensive measures is arguably less important.

Overall, the initial decision-rights choice is likely to be highly significant. Whilst in some jurisdictions, notably the U.S., the deployment of additional strategies, especially the reward strategy, may produce a result in which the outcomes of the joint decision-making process are not significantly different (in terms of deterring value-enhancing bids) from those arrived at under the nofrustration rule, this conclusion is highly dependent upon those additional strategies being available and effective. In the absence of pro-shareholder courts with effective review powers, easy removal of incumbent management or the ability to offer significant financial incentives to management to view the bid neutrally, rejection of the nofrustration rule is likely to reduce the number of control shifts.[107]

[101] E.g. contractual golden parachutes.

[102] Lucian Bebchuk and Jesse Fried, Pay Without Performance (2004) 89–91; Alessio M. Pacces, Rethinking Corporate Governance: The Law and Economics of Control Powers (2012) ch. 3.3 (welcoming such a result on theoretical grounds as enabling a manager/entrepreneur to be compensated for idiosyncratic private benefits of control on a control shift, at a lower level of ownership of the company than she would aim for if such side-payments were not available); Bengt Holmstrom and Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 Journal of Economic Perspectives 121 (2001).

[103] BGH 21 December 2005, Neue Juristische Wochenschrift 2006, 522. See also Chapter 3.3.2.

[104] Gerald Spindler, *Vorstandsvergütungen und Abfindungen auf dem aktien- und strafrechtlichen Prüfstand—Das Mannesmann-Urteil des BGH*, ZIP-Zeitschrift für Wirtschaftsrecht 349 (2006).

[105] Companies Act 2006, sections 219, 222(3), and 226C.

[106] Cf. Gordon, note 99, at 555 ("One way to understand [golden parachutes and accelerated stock options] is as a buyback by shareholders of the takeover–resistance endowment that managers were able to obtain from the legislatures and the courts during the 1980s").

[107] See ibid. (making these points in relation to Germany, where neither easy removal of the board nor high-powered incentives to accept offers are available).

8.2.4 Pre-bid defensive measures

It has often been pointed out that a major limitation of the nofrustration rule is that the requirement for shareholder approval of defensive tactics applies only once a bid is in contemplation.[108] This formulation of the nofrustration rule generates powerful incentives for managements at risk of a bid to act effectively against potential offers before they materialize. Moreover, developments elsewhere in company and securities law may enhance these possibilities. For example, mandatory and rapid disclosure of the beneficial ownership of voting shares helps incumbent management by increasing the time available to them to prepare defensive steps. Most jurisdictions now have rules requiring the beneficial holders of shares in listed companies, whether acting alone or in concert, to disclose that fact to the company and the market when certain minimum levels are exceeded,[109] and increasingly economic interests in shares are brought within the disclosure obligation.[110] The beneficial owner may be required to disclose not just the fact of the ownership, but also its intentions in relation to control of the company.[111] Some jurisdictions go further and give companies' charters the power to trigger disclosure at lower levels than the lowest statutory threshold.[112]

Following the EU's High Level Group, we can identify six categories of pre-bid defensive measures:[113] (a) barriers to the acquisition of shares in the company (for example, ownership caps or poison pills[114]); (b) obstacles to gaining control in the general meeting (voting caps; multiple voting shares); (c) limits on the ability to control the board of directors (codetermination, staggered boards, special appointment rights for some shareholders); (d) arrangements preventing control of the company's assets (lock-ups); (e) the creation of financial or management problems for the acquirer as a result of the acquisition (poison debt); and (f) actions raising regulatory issues (such as engaging in defensive acquisitions creating antitrust problems if the

[108] See Paul Davies, *The Regulation of Defensive Tactics in the United Kingdom and the United States*, in European Takeovers: Law and Practice 195 (Klaus J. Hopt and Eddy Wymeersch eds., 1992). If a defense put in place pre-bid requires action on the part of the board post-bid to be effective, it will be caught by the nofrustration rule (e.g. post-bid, shareholder approval is needed to issue shares which the board had previously been authorized to issue).

[109] Most national laws require regular disclosure at the 5 percent or 3 percent mark. See e.g. Transparency Directive 2004/109, Art. 9(1): initial disclosure at 5 percent, but member states can introduce a lower threshold. See Chapter 6.2.1.1.

[110] See new Art. 13(1)(b) of Transparency Directive 2004/109/EC, as revised in 2013. For the U.S., see *CSX Corp v. The Children's Investment Fund (UK) LLP* 562 Federal Supplement 2d 511 (2008), bringing equity swaps within Securities Exchange Act 1934 § 13(d). On the policy discussion around such requirements, see Maiju Kettunen and Wolf-Georg Ringe, *Disclosure Regulation of Cash-Settled Equity Derivatives—An Intentions-Based Approach*, Lloyd's Maritime & Commercial Law Quarterly 227 (2012). On creeping acquisitions, see Section 8.3.4.

[111] § 13(d) Securities Exchange Act 1934 (U.S.); Art. L.233-7, VII Code de commerce (France), where this additional information is required at the 10 percent, 15 percent, 20 percent, and 25 percent levels; Wertpapierhandelsgesetz (WpHG) § 27a, only at the 10 percent level (Germany); Art. 27-23 et seq. of the Financial Instruments and Exchange Act 2006 (Japan).

[112] See Art. L. 233-7, III Code de commerce (France) and Part 22 of the Companies Act 2006 (UK). The European Commission proposed in 2014 to give all EU companies on top-tier markets the right to obtain disclosure of beneficial ownership at the 0.5 percent level in its suggested amendments to the (in this context, inaptly named) Shareholder Rights Directive.

[113] *Report of the High Level Group of Company Law Experts Issues Related to Takeover Bids*, Brussels, January 2002, Annex 4. Some of these defensive steps could be taken, of course, post-bid as well.

[114] A poison pill may be adopted pre- or post-bid, normally the former. However, there is still a post-bid issue, namely, whether the directors redeem the pill (i.e. remove the shareholder rights plan), their unilateral power to do this being a central part of the scheme.

hostile bid is successful).[115] Another effective pre-bid defense could be change-of-control clauses in executive contracts, such as the ones recently upheld by the French Supreme Court.[116]

It would be too great an interference with the operation of centralized management to apply the no frustration rule when no bid is on the table, at least on the basis of an "effects" test.[117] Any commercial decision which might have the effect of deterring a future bidder for the company would then have to be approved by the shareholders. Nevertheless, one might think that the nofrustration rule would be ineffective unless accompanied by some type of pre-bid controls. A number of legal strategies are available. The most general of these are the standards applied by company law to all board decision-making (duties of care and loyalty). These standards are necessarily less constraining than the no frustration rule, for the reasons just given. Typically, some form of a "primary purpose" rule is used to distinguish legitimate from illegitimate decisions taken pre-bid which have defensive qualities as well as commercial rationales.[118] Such rules necessarily give management considerable freedom to take action for which there is a plausible commercial rationale, even if that action has defensive qualities of which the directors are aware and welcome, for example, an acquisition of assets which will create competition problems for a future bidder or which will put a block of shares into friendly hands.[119]

Rules dealing with specific decisions may be more constraining, but are necessarily also of less general import. Rules on significant transactions may require shareholder approval of certain types of pre-bid corporate action with defensive qualities.[120] We saw above that rules on shareholder consent to capital issues have placed obstacles in the way of the straightforward adoption of "poison pills" in Europe.[121] Here, pre-bid, the joint decision-making process is the more pro-shareholder choice, since the available alternative is not unilateral decision-making by shareholders but unilateral decision-making by the board. However, these veto rights for shareholders are generally driven by more general corporate law concerns than the control of pre-bid defensive measures and, hence, have a somewhat adventitious impact on control shifts.

Overall, management is necessarily given greater freedom to entrench itself pre-bid than post, and the legal strategies used to control managerial opportunism pre-bid are simply the general strategies used to protect the shareholders as principals and against the management as agents which are discussed elsewhere in this book.[122] Nevertheless,

[115] See also European Commission, *Report on the Application of Directive 2004/25/EC on Takeover Bids*, 28 June 2012, COM(2012) 347, para. 14.

[116] Cour de cassation, decision of 26 January 2011 (nº 09-71271), *Havas*.

[117] Of course, the precise point at which the line between pre- and post-periods is drawn can be the subject of some debate. The Takeover Code draws it once the board "has reason to believe that a bona fide offer might be imminent" (Rule 21.1: see Section 8.2.2), whilst the Takeover Directive's (default) no frustration rule applies only when the board is informed by the bidder of its decision to make an offer (Arts. 9(2) and 6(1)).

[118] On the UK "proper purpose" rule, see recently *Eclairs Group Ltd v JKX Oil & Gas Plc* [2015] UKSC 71.

[119] Even post-bid the courts may have difficulty applying the primary purpose rule so as to restrain effectively self-interested defensive action. See the discussion of the *Miyairi Valve* litigation in Japan by Kozuka, note 86, at 10–11. See also *Harlowe's Nominees Pty Ltd v Woodside (Lake Entrance) Oil Co.* 42 Australian Law Journal Reports 123 (High Court of Australia) (1968).

[120] See Chapter 7 for a discussion of the extent to which significant decisions require shareholder approval.

[121] See Section 8.2.3.

[122] See Chapters 3 and 7. The "breakthrough rule" is an exception to this statement. See Section 8.4.2.2.

in the hands of sophisticated shareholders who are able to coordinate their actions, pre-bid approval requirements can be effective.[123]

8.3 Coordination Problems among Target Shareholders

When an offer is put to the shareholders of the target company, they face, potentially, significant coordination problems. This is because the decision to accept or reject the bid is normally made by the shareholders individually, rather than by way of a collective decision which binds everyone, and so there is considerable scope for a bidder to seek to divide the shareholder body. This problem arises in both controlled and widely held firms: naturally, collective action problems will be larger in a dispersed ownership scenario; but minority shareholders of a controlled target company will be subject to similar coordination obstacles, in particular in agreed (friendly) bids.

In both ownership environments, the coordination issues of (minority) shareholders may be mitigated to some degree through the target board's negotiations with the potential acquirer.[124] Under the joint decision-making model, the board is in a strong position to negotiate in this way (though it may prefer to negotiate in its own interests),[125] whilst even under the nofrustration rule, the board retains non-trivial powers to protect the shareholders' interests, as we have seen.[126] However, if there is effective specific regulation of the shareholders' coordination problems, there is less need for incumbent directors to perform this role, and the risks of board entrenchment are reduced.

We now turn to examine the legal techniques which can be deployed to reduce target shareholders' coordination costs. To some extent, these strategies also address the agency costs, as described above.[127] We need to note that all these techniques have costs, in particular by reducing potential bidders' incentives to make offers. The main strategies deployed are a mix of *ex ante* rules (mandatory disclosures) and the trusteeship strategy; and, *ex post*, a combination of the reward strategy (sharing requirement) and an exit right.

8.3.1 Disclosure

Provision of up-to-date, accurate, and relevant information can help target shareholders with both their coordination and agency problems. In particular, disclosure of information by target management reduces the force of one of the arguments in favor of the joint decision-making model, that is, that managers have information about the target's value which the market lacks.[128] Even without regulation, information will be disclosed voluntarily in the bid process, but regulation may force disclosure of

[123] For the argument that this explains the absence of widespread non-voting and weighted-voting shares in the UK, despite its strong nofrustration rule, see Paul Davies, *Shareholders in the United Kingdom*, in Research Handbook on Shareholder Power 355 (Randall Thomas and Jennifer Hill eds., 2015).

[124] Note that in a controlled target company, the blockholder may have direct negotiations with the bidder; alternatively, the board may be controlled by the blockholder so that the real bargaining partner would also be the blockholder.

[125] See Section 8.2.3.1. [126] See Section 8.2.2.1. [127] See Section 8.2.

[128] Ronald J. Gilson and Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, in After Enron 57 (John Armour and Joseph A. McCahery eds., 2006), noting, however, that target management may find it difficult to make the disclosed information credible.

information which bidder or target would rather hide and discourage unsubstantiated and unverifiable claims.

Company law, of course, contains information disclosure provisions which operate independently of control transactions. However, annual financial statements are often out of date and, despite the continuing reporting obligations applied to listed companies in most jurisdictions,[129] it is likely that both the target board and the acquirer will be better informed about their respective companies than the target shareholders. Thus, it is not surprising that all jurisdictions have an elaborate set of provisions mandating disclosure by both the target board and the acquirer for the benefit of the target shareholders. It is routine to find rules requiring the disclosure of information on the nature of the offer, the financial position of the offeror and target companies, and the impact of a successful offer on the wealth of the senior management of both bidder and target.

It is common to accompany the disclosure requirements with an obligation to obtain and make available an independent opinion on merits of the offer. The independent opinion is facilitated by the disclosure requirements, as are assessments by third parties, such as securities analysts. Independent advice is particularly important in a management buy-out. Here incumbent management appears in a dual role: as fiduciaries for the shareholders and as buyers of their shares. Equally, where a competing bid emerges, whether in an MBO context or not, rules requiring equal treatment of the bidders in terms of information provided to them by the target make it less easy for target management to further the cause of their preferred bidder.[130]

In addition, takeover regulation requires offers to be open for a certain minimum time (practice seems to coalesce around the 20-day mark) and revised offers to be kept open for somewhat shorter periods,[131] in order that target shareholders and analysts can absorb the information. The main counterargument against very generous absorption periods is the need to minimize the period during which the target's future is uncertain and, in particular, during which the normal functioning of the centralized management of the target is disrupted.[132] In addition, mandatory minimum offer periods increase the opportunities for defensive measures by the target board or the emergence of a white knight, imposing a cost on acquirers and, possibly, upon shareholders of potential targets through the chilling effect upon potential bidders.[133] In

[129] See Chapter 9.1.2.5.

[130] In jurisdictions without takeover-specific regulation on the matter, it may be possible to leave the issue to general corporate law, notably the rules on self-dealing transactions. See Werner F. Ebke, *The Regulation of Management Buyouts in American Law: A European Perspective*, in European Takeovers: Law and Practice, note 108, 304–6—though it should be noted that the transaction here is technically one between the director (or associated person) and the shareholders, not the company. In the case of MBOs of close companies common law jurisdictions may deal with the grosser information disparities by imposing a duty on the directors to disclose information to the shareholders as an element of their fiduciary duties (see e.g. *Coleman v. Myers* [1977] 2 New Zealand Law Reports 225, NZCA). See also note 55.

[131] The Williams Act (note 33) in the U.S. was motivated in particular by the desire to control "Saturday night specials" i.e. offers to which the shareholders had an unreasonably short time to respond, the term being apparently used originally to refer to inexpensive hand-guns popular for use on Saturday nights.

[132] Designed to reduce the period the company is "in play," recent changes to the UK Takeover Code limit the freedom of acquirers to let it be known that they might make a bid but without manifesting a firm intention to do so: Rule 2.6, inserted 2011 (the "put up or shut up" rule). This provision seeks to remove uncertainty around market rumors or potential bid announcements and thus to improve the situation of target shareholders as against "virtual bids."

[133] See Section 8.2.2.2 for a discussion of competing bids and the passivity rule.

efficient securities markets, moreover, new information is rapidly impounded into the share price, and so it is likely that the main practical effect of the minimum periods is to allow new information to be generated and to facilitate competing bids rather than to promote understanding of the information disclosed.

8.3.2 Trusteeship strategy

Target shareholders face the risk that the incumbent management will exaggerate the unattractive features of a hostile bid and do the opposite with a friendly one. As we have seen immediately above, an *ex ante* common response is to require the incumbent management to obtain "competent independent advice" on the merits of the offer (usually from an investment bank) and to make it known to the shareholders. This is partly a disclosure of information strategy and partly a trusteeship strategy: the investment bank does not take the decision but it provides an assessment of the offer, the accuracy of which has reputational consequences for the bank. Particularly sensitive items of information, such as profit forecasts, may be subject to third-party assessment. Where there is an MBO, the directors involved in the bidding team may be excluded from those responsible for giving the target's view of the offer, thus allocating that responsibility to the non-conflicted directors of the target.[134] *Ex post* liability rules may add something to the *ex ante* incentives to be accurate.

8.3.3 Reward (sharing) strategy

A notable feature of laws aimed at solving target shareholders' coordination problems is their adoption of the equal treatment rule—though this principle can be implemented with varying degrees of rigor. The principle stands in the way of acquirers that wish to put pressure on target shareholders to accept the offer, by promising some (normally those who accept early) better terms than others.[135] In general, systems which place decision-making on the bid in the hands of the shareholders alone have developed the equality principle more fully than those which have adopted the model of joint decision-making.

All systems recognize the equal treatment principle to some degree. It can be applied, first, within the offer (i.e. that the offer addressees receive the same terms[136]); second, as between those who accept the offer and those who sell their shares to the offeror outside the offer, whether before or after a formal offer is launched; and, third, as between those who sell their shares to an acquirer as part of a control-building acquisition and those who are left as shareholders in the company. In this third case, implementation of the equality principle goes beyond a sharing strategy and involves providing an exit right for the target shareholders.

The first level of equality is recognized in all our jurisdictions. Thus, "front-end loaded" offers are ruled out; and prior acceptors receive the higher price if the offer is later increased. However, instead of formulating differential general offers, the acquirer may seek to offer some target shareholders (in particular, a blockholder) preferential terms by obtaining their shares outside the offer. One solution is to prohibit purchases outside the offer, though this rule can be sensibly applied only to purchases during

[134] UK Takeover Code, Rule 25.2 (notes 4 and 5).
[135] Paul Davies, *The Notion of Equality in European Takeover Regulation*, in TAKEOVERS IN ENGLISH AND GERMAN LAW 9 (Jennifer Payne ed., 2002).
[136] Or equivalent terms, where the offer covers more than one class of share.

or close to the offer period.[137] An alternative strategy is to require the offer consideration to be raised to the level of the out-of-bid purchases.[138] Where such purchases are permitted during the offer period, the imposition of a sharing rule seems universal. Some jurisdictions go further and impose a sharing rule triggered by recent pre-bid purchases.[139] A pre-bid sharing rule gains considerable importance where the target company is controlled by a blockholder, since the consequence is that the takeover premium paid to the blockholder effectively has be shared with all other minority shareholders, if the acquirer launches a general offer soon after the acquisition of the block. Many jurisdictions in fact mandate such an offer, as we shall see in the next section.

8.3.4 Exit rights: Mandatory bid rule and keeping the offer open

The strongest, and most controversial, expression of the sharing principle is the requirement that the acquirer of shares make a general offer to the other shareholders once it has acquired sufficient shares (whether on or off market) to obtain control of the target. Control is usually defined as holding 30 percent (or one-third) of the voting shares in the company.[140] This is the mandatory bid rule.[141] It is a particularly demanding rule if, as is common, it requires that the offer be at the highest price paid for the controlling shares[142] and that shareholders be given the option of taking cash.[143] Here the law, in imposing a duty on the acquirer to make a general offer, provides the shareholders with a right to exit the company and at an attractive price. The mandatory bid rule does not simply structure an offer the acquirer wishes in principle to make, but requires a bid in a situation where the acquirer might prefer not to make one at all.

Such a requirement might be defended on two grounds. First, the absence of a mandatory bid rule would permit the acquirer to put pressure on those to whom offers are made during the control acquisition process to accept those offers, for fear that any later offer will be at a lower level or not materialize at all. Where the offer is value-decreasing or its impact on the target is just unclear, use of the mandatory bid rule to

[137] See e.g. in France Art. 231-41 Règlement Général de l'AMF, which prohibits market purchases of the target shares during the offer period in share exchange offers because of the risk of market manipulation, with an exception for share repurchase programs (Viandier, note 71, at 367). In cash bids, the bidder is not allowed to acquire securities of the target during the "pre-offer" period, i.e. the period between publication of the terms of the offer and the formal offer, if the terms had to be published earlier due to rumors in the market (Art. 231-38, II Règlement Général de l'AMF).

[138] Again, French law provides an example: where the bidder acquires securities of the target during the offer period at a higher price, the offer price will be revised accordingly (Art. 231-39 Règlement Général de l'AMF).

[139] Rules 6 and 11 UK Takeover Code (but requiring cash only where the pre-bid purchases for cash reach 10 percent of the class in question over the previous 12 months); WpÜG § 31 and WpÜG-Angebotsverordnung § 4 (Germany) (requiring cash at the 5 percent level but only where that percentage was acquired for cash in the six months prior to the bid). The Takeover Directive does not require sharing in this situation.

[140] That is most common within the EU. See Commission's Report on the Implementation of the Directive on Takeover Bids (SEC(2007) 268, February 2007), annex 2. For alternative approaches worldwide, see Umakanth Varottil, *Comparative Takeover Regulation and the Concept of 'Control'*, Singapore Journal of Legal Studies 208 (2015).

[141] The additional issues arising when a mandatory bid rule is imposed upon an acquirer who obtains the control block from an existing controlling shareholder are discussed Section 8.4 and 8.4.2.

[142] The Takeover Directive, Art. 5(4), imposes a highest price rule, subject to the power of the supervisory body to allow dispensations from this requirement in defined cases. But see the system in Brazil, Section 8.4.2.1.

[143] The Takeover Directive permits the mandatory bid to consist of "liquid securities" but some member states (e.g. UK Takeover Code rule 9.5) require the offer to be in cash or accompanied by a cash alternative.

remove pressure to tender thus addresses a significant coordination issue of the shareholders as against the acquirer. Where the bid is value-increasing for target company shareholders, it can be argued that providing the non-accepting shareholders with an exit right is not necessary. However, it may be difficult for the rule-maker to identify *ex ante* which category the offer falls into, so that the choice is between applying or not applying the mandatory bid rule across the board.

Moreover, though the offer may be value-increasing for the target company's shareholders as a whole, the non-controlling shareholders may not obtain in the future their pro rata share of that value, for example because of the extraction of private benefits of control by the acquirer. That leads to the second rationale for the mandatory bid rule. Permitting the acquisition of control over the whole of the company's assets by purchasing only a proportion of the company's shares encourages transfers of control to those likely to exploit the private benefits of corporate control. On this view, the mandatory bid rule constitutes a preemptive strike against majority oppression of minority shareholders by providing minority shareholders with an exit right at the point of acquisition of control.[144] It assumes that general corporate law is not fully adequate to police the behavior of controllers.[145] On this rationale, the mandatory bid rule should be accompanied by a prohibition on partial general offers, even where, through a pro rata acceptance rule, all target shareholders are treated equally. By extension, one would expect to find a rule requiring comparable offers to be made for all classes of equity shares in the target, whether those classes carry voting rights or not.[146]

Mandatory bid rules are now quite widespread. The Takeover Directive requires EU member states to impose a mandatory bid rule (whilst leaving a number of crucial features of the rule, including the triggering percentage, to be determined at national level).[147] However, the mandatory bid rule is not part of U.S. federal law nor the law of Delaware, where shareholders' coordination problems are dealt with by empowering target management.[148]

While popular among lawmakers and investors, the mandatory bid rule runs the risk of reducing the number of control transactions which occur. First, the implicit prohibition on partial bids makes control transactions more expensive for potential bidders: either the bidder offers for the whole of the voting share capital and, often, at a high price[149] or it does not offer for control at all.[150] Secondly, the mandatory bid

[144] The balance between this effect and its discouragement of efficient transfers of control is disputed. See Lucian Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Quarterly Journal of Economics 854 (1994); Marcel Kahan, *Sales of Corporate Control*, 9 Journal of Law, Economics and Organization 368 (1993). More recently Edmund-Philipp Schuster, *The Mandatory Bid Rule: Efficient, After All?*, 76 Modern Law Review 529 (2013).

[145] It constitutes, in the concept developed by German law, an example of *Konzerneingangskontrolle* (regulation of group *entry*). See Alessio M. Pacces, note 102, at ch. 7.4.5, arguing for reliance on fiduciary duties to control future diversionary private benefits of control rather than a mandatory bid rule. But cf. Caroline Bolle, A Comparative Overview of the Mandatory Bid Rule in Belgium, France, Germany and the United Kingdom 279–80 (2008), suggesting that the mandatory bid is more effective.

[146] The UK Takeover Code contains both such rules: see rules 14 (offers where more than one class of equity share) and 36 (partial offers).

[147] Art. 5 Takeover Directive. See note 140 and accompanying text.

[148] In any event partial bids are in fact rare in the U.S., due to the pervasiveness of poison pills.

[149] See note 142. The UK and France also require that a takeover bid be conditional upon reaching at least 50 percent of the shares, which also discourages low-ball offers. See Luca Enriques and Matteo Gatti, *Creeping Acquisitions in Europe: Enabling Companies to be Better Safe than Sorry*, 15 Journal of Corporate Law Studies 55, 78 (2015).

[150] See e.g. Clas Bergström, Peter Högfeldt, and Johan Molin, *The Optimality of the Mandatory Bid*, 13 Journal of Law, Economics & Organization 433 (1997); Stefano Rossi and Paolo Volpin,

rule may also require the bidder to offer a cash alternative when otherwise it would have been free to make a wholly paper offer. Thirdly, the rules fixing the price at which the acquirer must offer for the outstanding shares may expose the acquirer to adverse movements in the market between the acquisition of *de facto* control and the making of a full offer. The chilling effect of the rule is particularly intense where there is a controlling shareholder, but it occurs also where the acquirer builds up a controlling stake by acquisitions from non-controlling shareholders.[151]

Some, but by no means all, takeover regimes have responded to these concerns. A somewhat common technique is not to extend the rationale underlying the mandatory bid rule to a complete prohibition of partial general offers.[152]

Switzerland goes further and permits shareholders of potential target companies to choose between the protection of the mandatory bid rule in its full form or modifying it to encourage changes of control. The Swiss regulation permits the shareholders to raise the triggering percentage from one-third (the default setting) to up to 49 percent or to disapply the rule entirely.[153]

Mandatory bid rules tend to be complex, partly because of the need to close obvious loopholes. Thus, the rule will usually apply to those "acting in concert" to acquire shares,[154] not just to single acquirers, but the notion of a "concert party" is not self-evident.[155] It may also be possible to circumvent the rule by using derivatives that provide on their face only an economic interest in shares, or through a "creeping takeover," i.e. small acquisitions of shares spread out over a period of time, frequently exploiting loopholes in public disclosure or takeover laws.[156]

Additional complexity is generated where it is thought necessary to subordinate the policy behind the mandatory bid rule to more highly valued objectives, for example, where the threshold is exceeded in the course of rescuing a failing company. The

Cross-Country Determinants of Mergers and Acquisitions, 74 Journal of Financial Economics 277 (2004), showing that takeover premia are higher in countries with strong shareholder protection, especially those with mandatory bid rules.

151 On the other hand, the mandatory bid rule discourages acquisitions driven by the prospect of private benefits of control, in the form of diversion of corporate assets and opportunities to the controller, because it creates a risk to the acquirer that it will end up with all or nearly all of the shares and no one to expropriate.

152 Italy permits partial bids for *at least* 60 percent of the shares, provided that a majority of shareholders other than the offeror and connected persons approves the offer and the offeror has not acquired more than 1 percent of the shares over the preceding 12 months. (Legislative Decree No. 58 of 24 February 1998 (as amended) Art. 107). Japan, by contrast, permits general offers to acquire *up to* two-thirds of the shares via a tender offer to all shareholders or market purchases (Arts. 27-2(1), 27-2(5) and 27-13(4) of the Financial Instruments and Exchange Act; Arts. 8(5)(iii) and 14-2-2 of the Order for Enforcement of the Financial Instruments and Exchange Act). See Tomotaka Fujita, *The Takeover Regulation in Japan: Peculiar Developments in the Mandatory Offer Rule*, 3 UT Soft Law Review 24 (2011).

153 Börsengesetz (Switzerland), Arts. 22(2) and 32(1). These provisions must be contained in the company's charter. Total disapplication can be decided upon only before listing.

154 Takeover Directive, Art. 5. There is a considerable danger that the acting in concert extension will chill shareholder activism, a development which policymakers may or may not welcome. Contrast the Risk Limitation Act 2008 in Germany (discussed by Hopt, note 49, at III.B) with the Takeover Code, note 2 to Rule 9.1.

155 Leading to proposals for greater harmonization with the EU: see European Securities Markets Expert Group, *Preliminary Views on the Definition of Acting in Concert between the Transparency Directive and the Takeover Bids Directive*, November 2008. See more specifically Chapter 3.2.4.

156 Enriques and Gatti, note 149. The UK Takeover Code is unusual in applying the mandatory bid rule to any acquisition of voting shares by a shareholder holding between 30 and 50 percent of the voting shares. After the Loi Florange (note 71), French law comes close to this: Art. L. 433-3, I Code Monétaire et Financier.

Takeover Directive allows national authorities to identify specific situations in which the rule may be set aside. Member States have made ample use of this flexibility. The European Commission perceives these various derogations as a risk to the European level playing field,[157] but they may have the advantage of allowing for value-enhancing control shifts where they otherwise would not be made.

In addition to the mandatory bid rule, a minor form of the exit right can be found in the obligation imposed in some jurisdictions on an offeror to keep the offer open for acceptance, even after the acquirer has obtained the level of acceptances it sought.[158] This enables a shareholder, whose first preference is to reject the offer but who thinks the share price will suffer if the acquirer obtains control, to maintain the position of non-acceptance until it is clear that the acquirer has obtained control and to exit at that point under the offer terms.[159] This problem may be acute in a controlled company, where minority shareholders may not know whether the blockholder will accept the offer. This option is more effective than the often provided right to "sell out" to an acquirer who obtains a high proportion of the shares,[160] because it operates at whatever level the acquirer declares the offer "unconditional as to acceptances."

8.3.5 Acquisition of non-accepting minorities

The absence of a binding corporate decision in a control transaction may confer hold-up powers on the shareholders who do not accept the offer, despite the fact that the majority of the shareholder base has chosen to do so, in an attempt to extract better terms from the offeror. Failure to accept may also result from simple apathy or from an assessment that the new controller will run the company well so that staying in the company is the attractive option. Most jurisdictions provide, in one way or another, for the squeeze-out of minorities on the terms accepted by the majority, usually, however, only where a very high proportion of the shareholders have accepted the offer. The right to squeeze-out minorities facilitates the initial fixing of the level of the offer at less than acquirer's expected gains from the acquisition by taking off the table the options of remaining in the company or exiting at a price higher than the offer price. It thus encourages bids.[161]

In most jurisdictions, minority hold-ups or incentives not to tender are directly addressed by takeover-specific rules[162] which give the acquirer compulsory purchase

[157] See Commission Report, note 115, para. 17; European Company Law Experts, *The Application of the Takeover Bids Directive—Response to the European Commission's Report* (November 2013), section 3.

[158] See e.g. UK Takeover Code, rule 31.4 (but qualified by Rule 33.2); WpÜG, § 16(2) (Germany), both adopting a two-week period. In Italy, a similar rule applies, but limited to tender offers launched by someone already holding a stake higher than 30 percent, or by management. Art. 40-II, Consob Regulation on Issuers.

[159] Lucian A. Bebchuk, *Pressure to Tender: An Analysis and a Proposed Remedy*, 12 Delaware Journal of Corporate Law 911 (1987). See however Guhan Subramanian, *A New Takeover Defense Mechanism: Using an Equal Treatment Agreement as an Alternative to the Poison Pill*, 23 Delaware Journal of Corporate Law 375, 387 (1998).

[160] Art. 16 Takeover Directive. See Section 8.3.5.

[161] Mike Burkart and Fausto Panunzi, *Mandatory Bids, Squeeze-Outs and Similar Transactions*, in Reforming Company and Takeover Law in Europe, note 99, at 753–6.

[162] Some jurisdictions have both types of rule. In Germany the introduction of the squeeze-out power specific to control shifts was important precisely because of its presumption that the bid price is fair (WpÜG § 39a(3)), in contrast to endless opportunities to challenge the price under the general merger procedure (AktG § 327b). Under both specific and general squeeze-out mechanisms the courts are likely to be worried if the threshold is (to be) reached as a result of a bid by an already controlling

powers over the non-accepting minority.[163] The Delaware version is the "two-step merger," that is, a tender offer for the shares followed by a short-form merger of the new subsidiary with the acquirer (i.e. without a shareholder vote), taking advantage of the fact that Delaware law has a general provision allowing squeeze-out mergers at the 90 percent level.[164] The importance of the short-form squeeze-out to acquirers is reflected in its extension in 2013 to acquirers with less than 90 percent after the first step but nevertheless enough votes to obtain shareholder approval for merger (normally a majority of the issued shares).[165] Unlike the earlier procedure, the 2013 reform is takeover-specific, ie. the first-step general offer is now a mandatory element of the procedure.[166]

In many countries the right of the offeror at above the 90 percent level to acquire minority shares compulsorily is "balanced" by the right of minorities to be bought out at that level ("sell out"), a right which, again, may or may not be tied to a preceding takeover offer.[167] Functionally, the two are very different. A squeeze-out right promotes offers whilst a right to be bought out reduces the pressure on target shareholders to tender, though that objective is in fact better achieved by rules requiring the bid to be kept open for a period after it has become unconditional.[168]

8.4 Specific Issues upon Acquisition from a Controlling Shareholder

Where there is a controlling shareholder or shareholding group the allocation of the decision on the offer as between the shareholders alone and shareholders and target board jointly loses much of its significance, for, on either basis, the controlling shareholder is likely to determine whether the control shift occurs.[169] However, the shareholder–board agency issues are here replaced by minority–majority agency problems.

shareholder. See *Re Bugle Press* [1961] Ch 279, CA (UK) and *Re Pure Resources Inc*., 808 Atlantic Reporter 2d 421 (Del. Ch. 2002)—both in effect requiring the acquirer to show the offer to be fair.

163 Art. 15 Takeover Directive requires Member States to provide such a mechanism, provided that the offeror reaches at least 90 percent of the shares as an outcome of the bid.

164 DGCL § 253. And see Chapter 7.4.2.

165 Although the acquirer would win the shareholder vote, a vote is expensive for the newly acquired target because of the need to comply with proxy solicitation rules.

166 DGCL §251(h). Other conditions reinforce this orientation. The first step must be a tender offer for all the shares with voting rights in a merger, the merger must follow as soon as possible after the conclusion of the tender offer, the offer consideration must be that contained in the merger proposal, the procedure is open only to third-party acquirers (i.e. not existing controllers) and the target management must consent (i.e. "friendly" takeovers only).

167 Both types of rule are discussed in greater detail in Forum Europaeum Corporate Group Law, *Corporate Group Law for Europe*, 1 European Business Organization Law Review 165, 226 ff. (2000). The Takeover Directive requires both a squeeze-out and a sell-out right.

168 See Section 8.3.4. An offeror may be satisfied with a controlling stake short of the 90 percent level and thus not be subject to the sell-out right, whereas the "keep it open" requirement applies at whatever level the acquirer declares the bid to be unconditional.

169 This depends, of course, on the board being immediately responsive to the wishes of the majority. If it is not, even a majority holder may not be able to assert its will. For a striking example see *Hollinger Int'l v. Black*, 844 Atlantic Reporter 2d 1022 (2004, Del. Ch.), where the Delaware Court of Chancery upheld the power of the board of a subsidiary to adopt a poison pill in order to block a transfer by the controller of the parent of his shareholding in the parent to a third party. This case involved egregious facts. In particular, the controller of the parent was in breach of contractual and fiduciary duties (as a director of the subsidiary) in engaging in the transfer, and the transferee was aware of the facts giving rise to the breaches of duty. See also Chapter 4.1.3.1.

Since minority–majority conflicts are not unique to control transactions, it is possible to leave their resolution to the standard company law techniques analyzed in previous chapters. However, laws dealing with control shifts have tended to generate more demanding obligations for controlling shareholders which arise only in this context. There are two central issues. First, are the selling controlling shareholder and the acquirer free to agree the terms of sale of the controlling block without offering the non-controlling shareholders either a part of the control premium or an opportunity to exit the company? Second, may the controlling shareholder, by refusing to dispose of its shares, prevent the control shift from occurring?

8.4.1 Exit rights and premium-sharing

In dealing with sales of control blocks, the central question is whether the law imposes a sharing rule. This question may be approached either from the side of the selling controlling shareholder (i.e., by imposing a duty on the seller to share the control premium with the non-selling minority: sharing of the consideration), or, from the side of the acquirer (i.e., by imposing a duty upon the purchaser of the controlling block to offer to buy the non-controlling shares at the same price as that obtained by the controlling shareholder: sharing of both the consideration and the exit opportunity).

Looking first at obligations attached to the selling controlling shareholder, some jurisdictions in the U.S. have used fiduciary standards to impose a sharing rule.[170] However, despite some academic argument to the contrary,[171] U.S. courts have not adopted a general equality principle which might have led them to generate an unqualified right for non-controlling shareholders to share in the control premium. The law is probably best stated from the opposite starting point: "a controlling shareholder has the same right to dispose of voting equity securities as any other shareholder, including … for a price that is not made proportionally available to other shareholders," but subject to a requirement for fair dealing.[172] Provided self-dealing is effectively controlled, permitting sales at a premium price would give both seller and acquirer an appropriate reward for their extra monitoring costs.[173] Despite this, purchases of control from blockholders disjunct from the buy-out of minorities are rare in the U.S., possibly because private benefits of control are low and finance to acquire 100 percent of the shares is generally available.

As far as duties on the acquirer are concerned, many of the sharing rules discussed in Section 8.3 will operate in favor of minority shareholders against a shareholder purchasing a controlling block, for example, the rules determining the level of the consideration.[174] Consequently, an acquirer that wishes to obtain an equity stake in the target beyond that which the purchase of the controlling block will provide may find it

[170] As in looting cases: see *Gerdes v. Reynolds*, 28 New York Supplement Reporter 2nd Series 622 (1941); or where the sale can be identified as involving the alienation of something belonging to all shareholders: *Perlman v. Feldman*, 219 Federal Reporter 2d Series 173 (1955); *Brown v. Halbert*, 76 California Reporter 781 (1969).

[171] William Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 Harvard Law Review 505 (1965). For an incisive general discussion of this area see Robert Clark, Corporate Law 478–98 (1986).

[172] American Law Institute, Principles of Corporate Governance § 5.16.

[173] For the argument that in general the controlling shareholder should be free to transfer control, whether directly or indirectly, for the reason given in the text, see Ronald J. Gilson and Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 University of Pennsylvania Law Review 785, 793–6, 811–16 (2003).

[174] Section 8.3.3. In most cases these rules can be avoided if the acquirer is prepared to wait long enough before launching an offer for full control.

difficult to offer a sufficiently high price to the controlling shareholder to secure those shares if the rules require the subsequent public offer to reflect the price paid outside or prior to the bid. The greatest controversy, however, revolves around the question of whether the mandatory bid rule should be applied to a transfer of a controlling position, so as to require the acquirer to make a public offer, where it would otherwise not wish to do so, and on the same terms as those accepted by the controlling seller.

It can be argued that there is a vital difference between purchasing control from a blockholder and acquiring it from the market in a widely held company, because in the former case the minority is no worse off after the control shift than it was previously. However, such a view ignores the risks which the control shift generates for the minority. The acquirer, even if it does not intend to loot the company, may embark upon a different and less successful strategy; may be less respectful of the minority's interests and rights; or may just simply use the acquired control to implement a group strategy at the expense of the new group member company and its minority shareholders.[175] As noted above in relation to acquisitions of control, it is very difficult to establish *ex ante* whether the minority shareholders will be disadvantaged by the sale of the controlling block, so that the regulatory choice is between reliance on general corporate law to protect the minority against unfairness in the future and giving the minority an exit right at the time of the control shift.

Nevertheless, the costs of the mandatory exit right are potentially much greater in a situation of a control block sale than for acquisitions of control from dispersed shareholders. The acquirer no longer has the option of sticking with the control block it has purchased at a price acceptable to the seller. Under the mandatory bid rule it must now offer that price to the non-controlling shareholders as well. It may well face the situation that it cannot pay the existing controller the price it wants to consent to the deal (reflecting private benefits of control) without overpaying for the company as a whole.

If private benefits of control are high, the disincentive effect of a mandatory sharing of bid premiums will be significant.[176] Fewer control shifts will occur, even where the acquirer intends to increase the operational efficiencies of the target. In countries where controlling shareholders are common, this may be seen as a strong objection to the mandatory bid rule.[177] The adverse impact of the mandatory bid rule is further enhanced if it applies to indirect acquisitions of control.[178] On the other hand, the

[175] These are, of course, the arguments in favor of the mandatory bid rule, even where the seller is not a controlling shareholder. See Section 8.3.4.

[176] John C. Coffee, *Regulating the Market for Corporate Control*, 84 Columbia Law Review 1145, 1282–9 (1984); Bebchuk, note 144.

[177] See Luca Enriques, *The Mandatory Bid Rule in the Proposed EC Takeover Directive: Harmonization as Rent-Seeking?* in Reforming Company and Takeover Law in Europe, note 99, at 785. See further Pacces, note 102, at 335–7, arguing for the abandonment of the mandatory bid rule and for permitting the acquirer of the controlling block to make a post-acquisition bid at the higher of the pre- and post-acquisition market price of the target's shares. A further consequence of our analysis is that a harmonized mandatory bid rule across the EU will in fact produce very different impacts depending on the level of private benefits of control.

[178] Sometimes referred to as the "chain principle," i.e., a person acquiring control of company A, which itself holds a controlling block in company B; or a company using its own subsidiary A to acquire control in company B. Must the acquirer make a general offer to the outside shareholders of company B? Perhaps reflecting the British penchant for wholly owned subsidiaries, the Takeover Code starts from the presumption that an offer is not required (Rule 9.1, Note 8); German law, as befits its commitment to group law, starts from the opposite presumption but allows the supervisory authority to dispense with the obligation if the assets of the subsidiary are less than 20 percent of the assets of the parent (WpÜG §§ 35, 37 and WpÜG-Angebotsverordnung § 9(2) no. 3). See also similarly, for Italy, Art. 45 Consob Regulation on Issuers, as amended.

mandatory bid rule will discourage transfers to acquirers who intend simply to extract higher benefits of control than the existing controller: the exit right at a premium ensures that there will be no minority for the new controller to exploit.

8.4.2 Facilitating bids for controlled companies

The existence of controlling blocks of shareholders in public companies clearly constitutes a structural barrier to control shifts, if the controllers are unwilling to relinquish their position. However, there is not much company law can do about such barriers: "[c]oncentrated patterns of ownership represent … simply the existing condition of the economic environment."[179] Nevertheless, there are two avenues through which lawmakers can facilitate bids in a controlled shareholder environment. First, they may create exemptions from or impose a weaker version of the mandatory bid rule, so that its adverse impact on control shifts is diluted. Secondly, they may neutralize "technical" barriers to control shifts such as control-reinforcing mechanisms.

8.4.2.1 Weakening the mandatory bid rule

We have seen that the mandatory bid rule has a chilling effect on control shifts, irrespective of whether the target has dispersed or concentrated ownership. Given that the existence of a controlling shareholder in the target serves as a deterring factor itself, lawmakers may be tempted to consider the two elements together as excessive and thus attempt to weaken the impact of the mandatory bid rule. Seen in this light, the various exceptions, exemptions, and limitations of the mandatory bid rule thus may be there for a perfectly rational reason: a weak version of the mandatory bid rule may be more functional for a system of concentrated ownership.

An example of weaker versions of the mandatory bid rule are the so-called "partial" sharing rules that are in force in China and India.[180] Thus, in China, a mandatory bid needs only be for a minimum of 5 percent of the outstanding shares, which naturally dilutes its effect.[181] Similarly, the Indian version of the rule requires any acquirer exceeding 25 percent of the voting rights in the target company to make a mandatory tender offer for at least 26 percent of the shares of the target company.[182] Another version is the Brazilian requirement that a mandatory bid be made to all common shareholders, but only at 80 percent of the price paid to the controlling shareholder[183]—an implicit recognition of the exceptionally high private benefits that controlling shareholders enjoy in that country.[184] Moreover, the fact that the mandatory bid rule by law only applies to voting shares significantly reduces its scope given the high incidence of

[179] Ronald J. Gilson, *The Political Ecology of Takeovers* in European Takeovers: Law and Practice, note 108, at 67, discussing the difference between "structural" and "technical" barriers to takeovers.

[180] Armour, Jacobs, and Milhaupt, note 36, at 274 ff.

[181] *Measures for the Administration of the Takeover of Listed Companies* (China Securities Regulatory Commission, 27 August 2008, revised), art. 25, available at www.lawinfochina.com/display.aspx?lib=law&id=7043&CGid=. See Chao Xi, *The Political Economy of Takeover Regulation: What Does the Mandatory Bid Rule in China Tell us?*, Journal of Business Law 142 (2015).

[182] Securities Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 2011. See Umakanth Varottil, *The Nature of the Market for Corporate Control in India*, Working Paper (2015), at ssrn.com.

[183] Art. 254-A Lei das Sociedades por Ações. However, the Novo Mercado, Brazil's premium corporate governance listing segment, requires a mandatory bid rule at the same price paid to controlling shareholders. Art. 8.1 Novo Mercado Regulations.

[184] See Chapter 4.4.2.1.

non-voting preferred shares in Brazil's capital market.[185] All three jurisdictions provide examples of a cautious legal transplant: accepting the mandatory bid rule as worldwide best practice, but adjusting it to the specific regulatory environment in place. All three regimes thus avoid the costly effect of a full sharing rule.[186]

A different strategy would be an "optional" mandatory bid rule.[187] As we saw above, Swiss law serves as an example by permitting shareholders to modify or remove the rule in their charters.[188] Potential target shareholders can thus deliberately facilitate control changes in their company.

Other jurisdictions achieve a similar outcome in a much less transparent way. Even though EU member states all provide for a fully fledged mandatory bid rule as required by the Directive, the laws' lacunae and lax enforcement in some of them[189] may also be understood as functional to the purpose of mitigating the mandatory bid rule's chilling effects. For instance, German law—intentionally or not—allows for circumventions of the mandatory bid rule where the bidder acquires economic rather than legal interests in shares, or where a "creeping takeover" is combined with a voluntary bid at a deliberately low price.[190]

In light of these considerations, some commentators have even argued that takeover regulation should rather be "unbiased" instead of prescriptive, and let decision-makers on the individual company level decide on their level of control contestability.[191] Others caution against too far-reaching flexibility, citing potential real-life problems in controlled companies and asking whether the market will adequately price in the choices made by individual companies.[192]

8.4.2.2 Addressing technical elements: The breakthrough rule

Technical barriers to takeovers may be susceptible to regulation through corporate law. The breakthrough rule (BTR), which EU member states may impose or at least make available to companies on an opt-in basis,[193] constitutes an example of a legislative attempt to address technical barriers to control shifts.

The BTR aims to prevent boards and controlling shareholders from structuring the rights of shareholders pre-bid in such a way as to deter bids. Subject to the payment of compensation, it removes some restrictions on shareholders' transfer and voting rights once a bid is made, whether the restrictions are found in the company's charter or in contracts among shareholders (to which contracts the company may or may not be party).[194] Such restrictions are not permitted to operate during the offer period. More importantly, they are ineffective, and multiple voting shares will be reduced to one

[185] Art. 254-A Lei das Sociedades por Ações. The regulations of the Level 2 listing segment of the São Paulo Stock Exchange however impose a mandatory bid rule with respect to both voting and non-voting preferred shareholders at the same price paid to the controlling shareholder. Art. 8.1 Level 2 Regulations.

[186] Armour, Jacobs, and Milhaupt, note 36, at 274 ff.

[187] See Luca Enriques, Ronald J. Gilson, and Alessio M. Pacces, *The Case for an Unbiased Takeover Law (with an Application to the European Union)*, 4 Harvard Business Law Review 85 (2014).

[188] See Section 8.3.4.

[189] See Enriques and Gatti, note 149, at 76–9.

[190] Theodor Baums, *Low Balling, Creeping in und deutsches Übernahmerecht*, ZIP – Zeitschrift für Wirtschaftsrecht 2374 (2010).

[191] Enriques, Gilson, and Pacces, note 187.

[192] See Hopt, note 13, at 156–7; Johannes W. Fedderke and Marco Ventoruzzo, *The Biases of an "Unbiased" Optional Takeovers Regime: The Mandatory Bid Threshold as a Reverse Drawbridge*, available at ssrn.com.

[193] Arts. 11 and 12 Takeover Directive.

[194] Art. 11.

vote per share, at any shareholder meeting called to approve defensive measures under the no frustration rule[195] *and* at the first general meeting called by a bidder who has obtained 75 percent of the voting shares. At this meeting any "extraordinary right" of shareholders in relation to the appointment and removal of directors shall not apply either.[196] The overall aim of the BTR is to render contestable the control of companies where control has been created through (some) forms of departure from the notion of "one share one vote" or by shareholder agreements.

The break-through of voting restrictions during the offer period might be thought to be necessary to make the no frustration rule work effectively. The post-acquisition break-through is potentially more significant and gives the successful bidder an opportunity to translate its higher-than-75-percent stake into control of the company by placing its nominees on the board and by amending the company's constitution so that its voting power reflects its economic interest in the company.

The optional BTR has been an unsuccessful experiment, since only a few, small member states have chosen to make it mandatory. Further, the BTR is nowhere the default rule and no company in member states where it is optional appears to have opted into it.[197] A combination of two elements explains why so few member states opted for a mandatory BTR. On the one hand, the BTR does not catch simple controlling positions where the one-share, one-vote rule is observed, so that the majority of controlling positions within European companies were not affected by it; on the other, the BTR does not catch some departures from the one-share one-vote principle, such as pyramids:[198] these two circumstances together were enough to generate aggressive—and successful—lobbying by those that a mandatory BTR would have caught. The reason why no companies have opted into the BTR is even simpler: an opt-in at company level requires a supermajority vote of the shareholders in most cases, and controlling shareholders, still possessing their technical advantages, have weak incentives to vote in favor.

8.5 Explaining Differences in the Regulation of Control Transaction

We have analyzed control shift regulation along three dimensions, focusing mainly on two: the location of decision-making on the offer and the protection of target shareholders (especially non-controlling shareholders) against opportunism on the part of the acquirer (or acquirer plus controlling shareholder). The minor dimension was the responsiveness of the regulation to non-shareholder constituencies.

Two immediate conclusions can be drawn from our analysis. The first and negative conclusion is that none of the systems puts the goal of maximizing the number

[195] Section 8.2.2.

[196] Thus rights of codetermination (see Section 8.1.2.3) are not affected because these are normally not shareholder rights of appointment and will be contained in legislation rather than the company's articles.

[197] See Commission's Report on the Implementation of the Directive on Takeover Bids, note 140, at 7–8.

[198] See John C. Coates IV, *The Proposed 'Break-Through' Rule-Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, in Reforming Company and Takeover Law in Europe, note 99, 677, 683–4 (summarizing data suggesting that only a maximum of 4 percent of public firms in the EU would be affected, and arguing that the controlling shareholders in some of those might be able to avoid the impact of the BTR by increasing their holdings of cash-flow rights or moving to equivalent structures not caught by the BTR, such as pyramid structures and/or cross-holdings).

of control shifts at the center of their regulatory structures. The maximum number of takeovers is likely to be generated by a system which enjoins upon target management a rule of passivity in relation to actual or threatened takeovers (the first dimension) and which gives the acquirer the maximum freedom to structure its bid (the second dimension), whilst (non-)shareholder interests are ignored. None of our jurisdictions conforms to this pattern: the regulation of agency and coordination issues in takeovers is a better, if more complex, explanation of the goals and effects of national regulatory systems than the maximization of the number of bids.

Second, the overall characterization of a system requires that attention be paid to both the major dimensions of regulation.[199] A system which rigorously controls defensive tactics on the part of management may nevertheless still chill takeovers by, say, strict insistence upon equality of treatment of the target shareholders by the acquirer or the prohibition of partial bids. Indeed, it is probably no accident that those systems which, historically, most clearly favor shareholder decision-making in bid contexts (UK and France—the latter now only doubtfully in this category) also have the most developed rules against acquirer opportunism, addressing intra-shareholder coordination problems. Deprived of the protection of centralized management, the target shareholders need explicit regulatory intervention as against acquirers, but that intervention—notably the mandatory bid rule—may also protect indirectly incumbent management. A system configured in this way may both make it difficult for incumbent management to entrench themselves against tender offers which do emerge and reduce the incidence of such offers. Which effect is predominant in practice is an empirical question.[200]

8.5.1 Differences in form and differences in substance

The most sensitive question in relation to control transactions is whether they can be implemented over the opposition of the incumbent board. So, the crucial dividing line appears to lie between those systems which place the decision on the control transaction wholly in the hands of the target shareholders and those which give both target shareholders and the board a veto right.

However, there are reasons for thinking that this division may be an over-simplification. First, a jurisdiction following the joint decision model may develop adaptive mechanisms which, to a greater or lesser extent, reproduce the effects of an allocation wholly to the shareholders of the target company. The U.S. demonstrates the possibilities for a development of this kind.[201] Thus, Armour and Skeel have observed that, whilst the proportion of hostile bids in the U.S. is smaller than in the UK,[202] which allocates the decision entirely to the shareholders, the overall level of control shifts is not much different.[203] In other words, a combination of legal strategies and

[199] See also Sanford J. Grossman and Oliver Hart, *An Analysis of the Principal-Agent Problem*, 51 Econometrica 7 (1983).

[200] Martynova and Renneboog, note 12, table 2, show that in the 1990s European merger wave 58 percent of all hostile takeovers within Europe involved UK or Irish targets, as did 68 percent of all tender offers (hostile or friendly), whilst the premium paid for UK targets exceeded that paid for continental targets (at 235).

[201] See Section 8.2.3.1.

[202] Armour and Skeel, note 32, table 1; see also Coates, note 54, 253 (7 percent hostile bids in the UK versus 3 percent in the U.S.).

[203] Armour and Skeel, note 32, at 1741. Whether the two systems are functionally absolutely equivalent is not clear (see ibid. at 1742–3, arguing that the U.S. system has costs which the straightforward adoption of a no frustration rule avoids).

institutional facts may permit the shareholders to reap the benefits of joint decision-making over control shifts (shareholders overcome their coordination problems by using management to negotiate with the bidder on their behalf) without incurring the costs of this arrangement (notably management entrenchment). Where those legal strategies are not available or the institutional facts do not obtain, however, the initial allocation of the decision right will indeed be crucial.

8.5.2 Different regulatory environments

Ownership structure, industry structure, and complementarities already in place matter for the design of functional legal rules. Strategic choices will certainly also play a role.[204]

Thus, we might expect countries with concentrated ownership structures to be less reliant on takeovers as a corporate governance device, since managerial monitoring is arguably performed by corporate blockholders. These countries—actually the overwhelming majority of all jurisdictions worldwide[205]—might be less in "need" to deploy pro-bidders takeovers laws.[206] This could be an explanation for the reluctance of some continental European countries to support a mandatory board neutrality rule in the Takeover Directive.[207] Japan with its closely knit network of cross-shareholdings is also an example of a system where tools of external corporate governance other than hostile takeovers have prevailed historically—though cross-shareholdings have weakened in recent years.[208]

Likewise, we could hypothesize that different designs of a takeover framework may be more appropriate for different types of industry. A growing literature discusses the "varieties of capitalism" and how they impact on legal rules.[209] Thus, it could be argued that industries with certain types of productive technology need to make long-term commitments to employees as a quid pro quo for the employees' investment in firm-specific human capital or acceptance of flexible working. In such a scenario, takeovers might be perceived as disruptive to such long-term commitment and likely to produce a "breach of trust" by the acquirer towards the existing employees.[210]

Finally, the design of appropriate rules seems to be naturally influenced by the pre-existing body of laws and tools. In other words, complementarities and path dependencies are important factors for the design of laws. For example, they may explain a lot of the peculiar UK/U.S. divide described above. The UK system of company law has always been strongly shareholder-centered—the board's powers derive from the company's charter, not the legislation, and the charter is, formally, wholly under

[204] Guido Ferrarini and Geoffrey Miller, *A Simple Theory of Takeover Regulation in the United States and Europe*, 42 Cornell International Law Journal 301 (2009). See also Hopt, note 12, at 259.

[205] Marco Becht and Colin Mayer, *Introduction*, in The Control of Corporate Europe (Fabrizio Barca and Marco Becht eds., 2001).

[206] It could be argued that these countries should better focus on rules that address intra-shareholder agency costs directly, such as related party transactions. See Chapter 6.

[207] See Section 8.2.2.

[208] Joseph Lee, *Critical Exposition of Japanese Takeover Law in an International Context*, Working Paper (2016), at ssrn.com.

[209] See Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (Peter A. Hall and David Soskice, eds., 2001); Wendy Carlin and Colin Mayer, *How Do Financial Systems Affect Economic Performance?*, in Corporate Governance: Theoretical and Empirical Perspectives 137 (Xavier Vives ed., 2000).

[210] Shleifer and Summers, note 22; Paul Davies, *Efficiency Arguments for the Collective Representation of Workers*, in The Autonomy of Labour Law (Alan Bogg et al. eds., 2015).

the control of the shareholders;[211] directors can be removed at any time by ordinary shareholder vote. U.S. law has traditionally been more protective of the prerogatives of centralized management, whilst preserving the ultimate control of the shareholders.[212] Hence, allocating decision-making on control shifts wholly to the shareholders fitted well with established patterns of UK corporate governance, whilst in the U.S. board influence over control shifts was established in a more convoluted and, perhaps, less stable way, but one doctrinally consistent with its managerial orientation.[213]

In a similar vein, jurisdictions might choose to promote alternative elements of corporate governance as substitutes for an active takeover market.[214] It should be noted, however, that such alternative improvements will rarely be sufficient: the threat of a hostile bid usually remains "the most effective corporate governance mechanism."[215] Another important complementarity to consider is the regulatory framework addressing shareholder engagement. Over recent years, various policy initiatives have sought to promote active shareholder participation in corporate affairs. It has been pointed out that some elements of takeover regulation—most importantly, the mandatory bid rule in conjunction with the concept of "acting in concert"—may run against the policy goal of promoting shareholder engagement.[216]

8.5.3 Political economy considerations

Divergences in takeover regulation may also be explained by different political choices and perceptions in different jurisdictions. Chief amongst the driving factors here is a potential backlash against a perceived sale of strategic firms into foreign hands. Takeovers can make newspaper headlines—and broad-scale takeovers of companies by, in particular, foreign acquirers have the potential of being used for protectionist counteractions. This is even more likely during times of economic crisis, as the recent global financial crisis has demonstrated.[217] For example, Italy—briefly during the financial crisis—and more recently France opted out of the board neutrality rule contained in the EU Takeover Directive.[218] Even the traditionally takeover-friendly UK saw a fierce political debate after the 2009 takeover of iconic chocolate maker Cadbury by American food giant Kraft.[219]

[211] See Chapter 7.2. [212] See Chapter 3.5.

[213] Armour and Skeel, note 32, at 1767–8, point out that the traditional doctrinal pro-shareholder orientation of British corporate law was reinforced by the rise of institutional shareholding during the precise period that modern takeover regulation was being developed in the UK, i.e. in the 1960s, whereas this coincidence did not occur in the U.S. Equally, one might speculate that, if managerial stock option plans were to become a less significant part of compensation in the U.S., then U.S. institutional investors might begin to agitate for shareholder-friendly control-shift regulation.

[214] Paul Davies and Klaus J. Hopt, *Corporate Boards in Europe—Accountability and Convergence*, 61 American Journal of Comparative Law 301 (2013).

[215] Jonathan Macey, Corporate Governance: Promises Kept, Promises Broken 10, 118 ff. (2008). On the market of corporate control and the pros and cons of the nofrustration rule see Hopt, note 12, at 261–8.

[216] See ESMA, *Information on Shareholder Cooperation and Acting in Concert under the Takeover Bids Directive*, ESMA/2013/1642 (12 November 2013); Martin Winner, *Active Shareholders and European Takeover Regulation*, 12 European Company and Financial Law Review 364 (2014). See also Chapter 3.2.4.

[217] See a number of contributions in Company Law and Economic Protectionism (Ulf Bernitz and Wolf-Georg Ringe eds., 2010).

[218] See Sections 8.2.2 and 8.2.3.2.

[219] Some even called for the adoption of a specific "Cadbury's Law" to better protect British firms from foreign takeovers. See Wolf-Georg Ringe, *Deviations from Ownership-Control Proportionality—Economic Protectionism Revisited*, in Company Law and Economic Protectionism, note 217, at 235.

In many emerging markets, takeovers are generally very rare, mostly because of severe ownership concentration in the hands of families and the state, but also due to regulatory hurdles in those (rare) countries where ownership is a little more dispersed, such as India.[220] But even in developed Western economies, politicians may fall prey to the perceived need to "protect" the local economy from foreign bidders. A case in point is France, where policymakers of all parties regularly act or intervene to create or protect "national champions." Law and politics may frequently blend into each other. Consider the example of the 2014 acquisition of French industry champion Alstom by U.S. conglomerate General Electric (GE). Despite the fact that the French government was not a shareholder in Alstom, and despite there being no legal requirement to do so, it was clear as a matter of fact that GE had to (and did) negotiate directly with the Elysée Palace before it was eventually "allowed" to proceed with the bid. In the course of this takeover, the French government additionally adopted a legislative decree, protecting local key industries by an official government veto on control shifts.[221] In all jurisdictions such policies are common for sensitive industries, for example to shield the local defense industry from foreign influence.[222]

Apart from the perceived need to protect strategic industries, the reasons for public uproar are frequently the impact that takeovers have on the workforce. It is true that takeovers frequently lead to redundancies—though restructurings are not unique to takeovers. And it is no wonder that trade unions are amongst the most vociferous groups protesting against takeovers. Public attitudes are severely tested where—as for example in the above-mentioned Cadbury/Kraft transaction—previous promises to keep employment are broken after completion of the takeover.

Ultimately, then, this relates back to the many agency conflicts that control transactions generate, in particular for non-shareholder groups.[223] In those countries where company law is used to address company–employee agency issues as a matter of general practice via employee or union representation on the board (namely, Germany), a control shift effected simply by means of a transaction between the acquirer and the target shareholders, thus by-passing the corporate organ which embodies the principle of employee representation, is likely to be regarded with suspicion. Conversely, the freedom of management to take defensive measures may be seen as a proxy for the protection of the interests of employees and, possibly, other stakeholders.

8.5.4 Regulatory uncertainty

There is an important qualification to all the arguments made above. None of the various factors that may shed light on particular regulatory choices can explain them

[220] Armour, Jacobs, and Milhaupt, note 36, at 273 ff.; Érica Gorga, *Changing the Paradigm of Stock Ownership from Concentrated Towards Dispersed Ownership? Evidence from Brazil and Consequences for Emerging Countries*, 29 Northwestern Journal of International Law & Business 439, 445 (2009); Mariana Pargendler, *Corporate Governance in Emerging Markets*, in Oxford Handbook of Corporate Law and Governance (Jeffrey N. Gordon and Wolf-Georg Ringe eds., 2017).

[221] Hugh Carnegy, Michael Stothard, and Elizabeth Rigby, *French "Nuclear Weapon" against Takeovers Sparks Blast from Cable*, Financial Times, 16 May 2014, p. 1.

[222] Germany revised its Foreign Trade Act (*Außenwirtschaftsgesetz*) in 2008, establishing a review process for investments from outside the EEA if a company takes a stake in a German company of more than 25 percent. See Hopt, note 49, at 384 ff. Similarly, the U.S. review process for foreign investments—undertaken by the Committee on Foreign Investments in the United States (CFIUS)—was amended in 2007/8 to accommodate concerns that the process in its previous form had been ineffective and too lenient.

[223] See Section 8.1.2.3.

in their entirety, and most importantly, lawmakers face severe uncertainty as to the prevailing regulatory problem that they need to solve. For example, in relation to ownership structure, we know that the average size of the largest block varies from jurisdiction to jurisdiction,[224] so that in jurisdictions with medium-sized average blocks, hostile takeovers may be difficult, but not ruled out entirely. Further, consider the impact of changes over time: for example, there is evidence, in important jurisdictions, of a weakening of the grip of blockholders over the years.[225] Finally, even in jurisdictions dominated by large blockholders, shareholdings in particular companies atypically may be dispersed. Thus, there are very few jurisdictions in which hostile takeovers are fully ruled out on shareholder structure grounds. More importantly, over the last few decades the hostile bid has become a significant event in a number of jurisdictions where previously it was virtually unknown.[226]

Lastly, the desire of rule-makers to fit takeover rules into the existing parameters of corporate law will explain much of the responses in these situations. All those uncertainties and conflicting interests will become even more acute in heterogeneous, federal systems (such as the EU), where a common pattern is not observable.

Thus, it is fair to say that regulators are somewhat "agnostic" when it comes to choosing an appropriate takeover regime for their specific needs: even if we optimistically imagine that lawmakers seriously seek to optimize their takeover framework in the public interest by designing functional rules that fit to the assumed real-life business realities, they can never be sure that these assumptions hold true (i) for all business entities that they seek to regulate, (ii) across different industries, and (iii) over time. This agnosticism has two consequences. First, lawmakers will try to encapsulate the "typical" situation relevant for their jurisdiction by, for example, assuming that companies controlled by a blockholder are the "typical" (as distinguished from ubiquitous) situation they need to address. Secondly, regulators faced with continued uncertainty and conflicting pieces of real-life evidence will plainly be unsure on how to determine the optimal regime and so respond to other policy arguments. This is the point where political considerations, lobbying efforts, and regulatory capture fall onto fertile grounds. A good illustration is the adoption of the EU Takeover Directive, with the European Commission pushing for a pro-takeover response as an important tool for promoting an integrated "single market" within the Union,[227] whilst some member states (and the European Parliament) responded to current popular fears of globalization and its impact.[228] With the abandonment of the no frustration rule and the BTR

[224] Becht and Mayer, note 205, table 1.1, reporting that in the late 1990s the median size of the largest voting block in listed companies varied from 57 percent in Germany to 20 percent in France.

[225] For Germany, see Wolf-Georg Ringe, *Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG*, 63 American Journal of Comparative Law 493 (2015). For Japan, see Japan Exchange Group, 2015 ShareOwnership Survey (2016), at <http://www.jpx.co.jp/english/markets/statistics-equities/examination/01.html>.

[226] Julian Franks et al., *The Life Cycle of Family Ownership: International Evidence,* 25 Review of Financial Studies 1675 (2012), report in appendix A1 that the average number of listed companies which were the target of an unsolicited bid expressed as a percentage of all listed companies between 2001–6 was 0.9 percent in Germany; 1.1 percent in Italy; and 0.7 percent in France. The UK figure was 3.3 percent. The same general trend can be found in Japan, as the litigation it has generated attests: see note 51.

[227] For which policy there was considerable empirical support. See, for example, Marina Martynova and Luc Renneboog, *Mergers and Acquisitions in Europe*, in Advances in Corporate Finance and Asset Pricing 13, 20 (Luc Renneboog ed., 2006), stating that the European merger boom of the 1990s "boiled down to business expansion in order to address the challenges of the European market."

[228] See Klaus J. Hopt, *Observations on European Politics, Protectionism, and the Financial Crisis*, in Company Law and Economic Protectionism 13, 20–1 (Ulf Bernitz and Wolf-Georg Ringe eds., 2010).

as mandatory rules at EU level,[229] protectionists may be said to have had the better of the argument with pro-integration forces. This trend was repeated in the process of transposing the Directive, where, overall, there was a more protectionist approach on the part of the member states than had obtained previously.[230]

The sobering bottom line is that takeover regulation is a mixture of political interests, strategic consequences, lobbying efforts, and the external pressure of capital markets. At best, regulators will attempt to capture the "most typical" agency conflicts and coordination problems they need to address and ensure that they update their approach as and when real-life changes occur. As strict one-size-fits-all regulation rarely truly reflects business realities, takeover rules that allow for exceptions and/or discretionary decisions would seem to be welfare-improving, but there is no guarantee that the choices so provided are exercised in a way consistent with social welfare.[231]

[229] Section 8.2.2 and 8.4.2.2. [230] Davies et al., note 46. [231] Section 8.4.2.