7

Control Transactions

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7.1 Agency Problems in Control Transactions

7.1.1 Control transactions

In this chapter we consider the legal strategies for addressing the principal/agent 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.[1] We do not directly address the questions of whether such control shifts are value maximizing from the point of view of the shareholders of the acquired company or whether they are efficient in any more general sense.[2] However, as will be seen below, the cross-cutting agency issues in this area give rise to trade-offs in regulatory objectives, so that the choice on the part of any particular rule-maker to concentrate on the solution of one agency problem as against another does normally reflect a view about the desirability (or otherwise) of control transactions in public policy terms.

The core transaction in this chapter is one between a third party (the acquirer)[3] and the company's shareholders, whereby the third party aims to acquire the target company's shares to the point where it can appoint its nominees to the board of that company. This is what we mean in this chapter by

[1] Regarding principal/agent problems in general, see *supra* 2.1. Note that we will use the terms 'company' and 'corporation' as interchangeable.

[2] See generally Marco Becht, Patrick Bolton and Alisa Roell, *Corporate Governance and Control* (Working Paper 2002, available at ecgi.org) (empirical evidence is mixed and sketchy); Roberta Romano, *A Guide to Take-overs: Theory, Evidence and Regulation*, in Klaus J. Hopt and Eddy Wymeersch (eds.), European Takeovers: Law and Practice 3 (1992) (economic learning and regulatory policy have not marched in step). Empirical studies generally show that target shareholders gain significantly from takeovers, whereas the picture is murkier for bidder shareholders. See Kathleen Fuller, Jeffry Netter and Mike Stegemoller, *What do Returns to Acquiring Firms Tell Us? Evidence from Firms that Make Many Acquisitions*, 57 Journal of Finance 1763 (2002) (in the U.S., bidder shareholder gain when buying a closely held firm, but lose when purchasing a public firm); J. Harold Mulherin and Audra L. Boone, *Comparing Acquisitions and Divestitures*, 6 Journal of Corporate Finance 117 (2000) (sample of 1395 U.S. firms: both acquisitions and divestitures increase shareholder wealth); G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder?*, 55 Journal of Finance 2599 (2000) (sample of 2,346 takeovers: most deals described as hostile cannot be distinguished from friendly ones): Greg Jarrell and Annette Poulsen, *The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades*, 18 Financial Management 12 (1989) (shareholders of U.S. targets receive an average premium of 29% above pre-announcement share price).

[3] Of course, the acquirer may, and typically will, already be a shareholder of the target company, but it need not be and most of the relevant rules do not turn on whether it is or not.

'control transactions'. No doubt, this is a restricted definition of a control transaction: clearly, control may also pass to a new shareholder or set of shareholders as a result of transactions between *the company* and its shareholders or the investing public (as when a company issues or re-purchases shares).[4] However, control transactions involving corporate decisions can be analyzed in the same manner as other corporate decisions, a task we have already undertaken in this book, notably in Chapter 3 ('The Basic Governance Structure') and Chapter 6 ('Significant Corporate Actions'), and take further in Chapter 8 ('Issuers and Investor Protection'). 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 (as defined) a special character which warrants separate treatment in this chapter.[5]

Control transactions may be implemented in a variety of ways which can be used singly or, more likely, in combination: via private treaty with a small number of important shareholders, via purchases of shares on the market, or by way of a general and public offer to all the shareholders of the target company. In the case of the public offer it 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).[6]

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. Nevertheless, the control transaction is not logically confined to such companies and we make some reference to non-traded[7] companies as well. Non-traded companies, however, will constitute a minor theme in the chapter, because jurisdictions have tended to develop distinct regulation for control transactions in traded securities,[8] leaving control transactions for non-

[4] See also *supra* 4.1.2 (discussing 'control').

[5] 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.

[6] 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. In consequence, the friendly/hostile distinction is not analytically of great value.

[7] Throughout this book, corporations whose shares do not trade freely in impersonal markets are also referred to as 'closely held' companies. See *supra* 1.1 and Chapter 3, note 3.

[8] Traded securities are the centerpiece of regulation in all the following European countries as well as in Japan, though they vary somewhat in the extent to which they venture beyond that (for example, to take in companies whose securities were previously traded). For Japan, see Art. 27-2-(1) and Art. 24(1) Securities and Exchange Act (tender offer rules apply to reporting companies, i.e., companies that are publicly traded, have made a public offering or have 500 or more shareholders). For France, see Art. 1, *Règlement 2002–04, Commission des Opérations de Bourse* (hereafter Règlement COB) and Art. 5-1-1 *Règlement Général du Conseil des Marchés Financiers* (hereafter Règlement Général CMF) (from August 2003 the CoB and the CMF were amalgamated into the *Autorité des Marchés Financiers* (AMF), but for the moment the prior regulation remains in force); for Germany, §1 *Wertpapiererwerbs- und Übernahmegesetz* (hereafter Übernahmegesetz); for Austria, §1 Übernahmegesetz; for Switzerland, Art. 22 *Loi fédérale sur les bourses et le commerce des valeurs mobilières* (hereafter Loi sur les bourses); for Italy, Art. 105 Legislative Decree 58 (confining the rules on mandatory bids to securities traded on regulated markets, though the information provisions may apply more broadly—Art. 102). The British City Code applies slightly more widely (to all public companies and even to private companies where there has been something analogous to a public market in the private company's shares) (The Panel on Takeovers and Mergers, CITY CODE ON TAKE-OVERS AND MERGERS (7th ed., 2002) A8—hereafter City Code).

traded companies to be dealt with by the general governance rules of company law.[9]

To be sure, some jurisdictions have not adopted comprehensive takeover regulation as part of their securities laws and generally rely on corporate law to deal with control shifts. The most notable example of this approach is the U.S., where the (federal) securities laws focus on only limited aspects of control transactions.[10] Substantial areas of regulation are left to (state) corporation laws, both common law and statutory, which may apply to both publicly traded and closely held companies. Moreover, even in jurisdictions with fully developed and specialized takeover rules, some matters are still likely to be dealt with in general corporation law, if only for historical reasons.[11]

7.1.2 Agency issues

7.1.2.1 Where shareholdings in the target company are dispersed

A useful way to disentangle the various agency issues which can arise in control transactions is to assume initially that target company shareholdings are fully dispersed, i.e., that there exists no holder of a block of shares with whom the acquirer may be tempted to do a private deal. Because we take the view that the agency problems arising in situations where there is such a block-holder are significantly (though not completely) different, our analysis of the available legal strategies fundamentally distinguishes between companies with dispersed shareholdings and those with block-holders. We should make it clear, however, that the distinction refers to the situation in particular companies and not to the shareholder structure that is dominant in a given jurisdiction.[12] Nor do we assume that companies with controlling shareholders are not traded on public markets.[13]

[9] See *supra* Chapter 3, especially 3.2.

[10] In 1968 the Williams Act amended the Securities Exchange Act of 1934 to deal with some aspects of control transactions.

[11] See, e.g., provisions about the compulsory acquisition of minority shareholdings (discussed *infra* 7.3.5).

[12] As is now well established, dispersed shareholdings are more common in the U.S. and the UK and block-holders elsewhere. See Fabrizio Barca and Marco Becht (eds.), THE CONTROL OF CORPORATE EUROPE (2002); Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *Corporate Ownership around the World*, 54 JOURNAL OF FINANCE 471 (1999). Remember, however, that regulatory divergence regarding managerial power to interfere with the transferability of shares is highest among jurisdictions where dispersed shareholdings are common. See *supra* 3.1.2.5.

[13] No stock exchange requires that the public float embrace the whole of any class of the company's equity; and, even if it did, patterns of purchases on flotation or subsequently might lead to concentration of the shareholdings.

Where shareholdings are dispersed, the acquirer is likely to confine itself to the techniques of market purchases and a public offer. More particularly, the acquirer's strategy is likely to focus on a public offer to all the shareholders, coupled with the pre-bid acquisition, through the market, of as large a 'launch-pad' shareholding in the target as the acquirer can manage without revealing the subject of its intended offer. Unlike in the case of the company with concentrated shareholdings, the control shift effected by a successful general offer is not from those who have control (the block-holders) to the acquirer who wishes to obtain it. With dispersed shareholding, *de facto* control of the company is probably in the hands of the target board, so that in this case 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 specific agency problems. In any control transaction, whether control is located with block-holders or management, the directors of the target company potentially face severe conflicts of interest, for 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. Where, however, the incumbent management have control of the target, they are potentially in a position to take action to defend their position. They may seek to use that control to make the target less attractive to a potential bidder or to prevent the offer being put to the shareholders.

However, the principal/agent problems in a target company with dispersed shareholdings are not confined to the incumbent management. Even if it does not attempt to discourage (or promote)[14] the offer, there will be a set of agency issues as between the shareholders and the acquirer. In particular, the acquirer may pressurize shareholders of the target into accepting an offer which they think is less than optimal. There are a number of ways in which this can be done,[15] but in essence they all involve exploitation by the acquirer of the co-ordination problems which dispersed shareholders experience.

Here, it is useful to draw the contrast between shifts in control through statutory mergers[16] and control transactions. In terms of end result, there may not be much difference between a statutory merger and a share-exchange takeover bid, at least where the successful bidder avails itself of a mechanism for the compulsory purchase of dissenting minorities.[17] However, in terms of the legal

[14] The self-interest of the incumbent management may display itself in the promotion of offers to buy the company's shares, for example, where, as in a management buy-out, the management is connected with the offeror.

[15] See *infra* 7.3.2. [16] See *supra* 6.2.2.2.

[17] Thus, in the UK, the City Code applies to statutory mergers as well as to general offers, to the extent that the statutory merger procedure does not regulate a particular issue (City Code, C6—definition of 'offer'). Compare the acquisition of Bank Austria AG by Bayerische Hypo Vereinsbank, effected by a merger in order to avoid the new Austrian takeover legislation. See 4 NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT 282 (2001).

techniques used to effect the control shift, there is a chasm between the two mechanisms. A merger involves corporate decisions, certainly by the shareholders and often by the directors as well.[18] Control transactions, by contrast, are effected by private contract between the acquirer and the shareholders individually, with consequent scope for the acquirer to exploit uncertainty on the part of any one shareholder as to what the majority of the shareholders will decide.

7.1.2.2 Where shareholdings in the target company are concentrated[19]

Where there is an existing controlling block of shares held by one or a small number of shareholders, the acquirer is likely to come to an agreement with the block-holders first and decide whether, and on what terms, to make a general offer to the non-controlling shareholders only once such an agreement has been reached. As between the acquirer and the block-holder, it is likely that the standard provisions on commercial sales will cope well with any problems likely to arise.

However, the general rules of civil law are not likely to address effectively the agency issues between the block-holder and the acquirer, on the one hand, and the non-controlling shareholders, on the other. The controlling shareholder may engage in rent-seeking by selling control of the company to an acquirer who will 'loot' it; or, simply sell it to an acquirer who, perhaps for good commercial reasons, will be less respectful of the interests of non-controlling shareholders than the vendor has been. 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.[20]

7.1.2.3 Agency problems of non-shareholders

Finally, whatever the structure of the target company's shareholding, agency issues will arise as between the acquirer and non-shareholders, especially employees. In those countries where company law is used to address company/employee agency issues as a matter of general practice, for example, via standing employee or union representation on the board,[21] the extension of this function into control transactions may be feasible, even though there is no corporate decision involved.

Where company law is not normally used to address employee agency issnes, control transactions are unpropitious ground for regulation aimed at this problem. Faced with this difficulty, one may come to view the ability of incumbent management to resist a control transaction as a proxy for rules which directly address the agency issues of employees. As we shall see,[22] the closeness of the 'fit'

[18] See *supra* 6.2.

[19] All jurisdictions will face such situations, even if the typical pattern of shareholdings in companies in that jurisdiction is the dispersed one. See *supra* note 12 and accompanying text.

[20] See *supra* 4.1.2. [21] See *supra* 3.3. [22] *Infra* 7.5.

between the ahility of management to defend itself and the interests of non-shareholder stakeholders is contentious.

7.1.2.4 *The nature and scope of takeover regulation*

Many of the agency problems of control transactions are familiar from earlier chapters of this book. However, they appear in this chapter in a novel context. A centtal feature of that context is the tension between a commitment to the free transferability of shares and a recognition that sales of shares sufficient to produce a control shift have consequences for the policies of the company which would normally call for a decision of either the board or the general meeting (or, of course, both). This point is as valid for transfers from existing controlling shareholders as it is for transfers of control from the board of the target. Moreover, the control transaction brings onto the scene a new actor, namely the acquirer, whose activities both generate new agency problems (arising, for example, out of the mauner in which the offer to the shareholders of the target is formulated) and reveal the traditional agency problems (for example, that between shareholders and management of the target) in a novel and more complicated setting.

There are two groups of issues relating to takeovers, which are important determinants of the level of takeover activity but which we, following national patterns of regulation, will not deal with in this chapter. First, we shall not consider 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. This is but an example (albeit an important one) of rhe general agency problems existing between shareholders (and creditors) and boards in relation to setting the corporate strategy, which have been fnlly analyzed in an earlier chapter.[23]

Second, we shall not consider what are usually referred to as the 'structnral' barriers which a potential bidder may face, i.e., 'existing conditions in the economic environment'[24] which may discourage the making of offers to acquire, such as the concentration of shareholdings in small groups of family sharehold-ers who are unwilling to sell out. There is probably little company law can do about such problems.

Takeover regulation also tends not to deal with issnes arising once the acquirer has obtained control of the target company and sets about the task of integrating the target into the acquirer's overall business operations. This may not be a straightforward task, legally, if non-accepting shareholders remain opposed to the acquirer. The acquirer can protect itself against this by making the offer condi-tional on the acceptance of the offer by whatever proportion of the target capital it thinks fit. Further, as we shall see below, the law may facilitate the compulsory

[23] See *supra* 3.1 and 3.3.

[24] Ronald J. Gilson, *The Political Ecology of Takeovers*, in Hopt and Wymeersch, *supra* note 2, 49, 66.

purchase of small dissenting minorities.[25] However, the situation looks very differeut if control rights are not equally distributed across the company's equity capital. If, fot example, the company's constitution contains mnltiple or dual voting rights for some of the eqnity shares or rights of some shareholders to nominate board members, an acquirer may obtain acceptances from, for example, over three-quarters of the target's equity shares, but not be able to exercise effective control over the company.

This possible outcome may deter potential offerors from making the heavy financial commitment of a bid in the first place. Despite their importance for takeover regulation, such problems are usually left to general company law, since they are seen as a more general example of the shareholder/board agency relatiouship. However, this issue has been pushed into the area of EU takeover regulation in 2001 by the last minute opposition to the draft Takeover Directive by the German Government, on the ground that its industry, in comparison with other European countries, was lacking the protection of post-acquisition obstacles to the assertion of control.[26] As a result, the (ultimately optional) 2002 re-draft of the Takeover Directive provided that, where an acquirer, post-bid, has the number of securities which wonld normally enable it to alter the target's articles under national law, any restrictions to be found in the company's articles or in a shareholder agreement on the transfer of shares or on the exercise of voting rights should be withont effect at the first geueral meeting of the company after the bid.[27] In this way, takeover regulation is making further inroads into general corporate law and we shall discuss the issue in this chapter.

7.2 Agency Problems Where Shareholdings are Dispersed: Two Models of Regulation

7.2.1 Basic models

We begin with the twin agency problems which arise where an acquirer makes a general offer to the shareholders of a target company whose shareholdings are dispersed. The two agency problems arise between target shareholders and target management, and target shareholders and the acquirer. We suggest that the crucial initial question is the allocarion of *decision rights* on the offer, more particularly, rhe division of decision rights as between the target shareholders and target board on this matter.

[25] See *infra* 7.3.5.

[26] The Commission's Proposal for a Takeover Directive would have mandated target board neutrality during the bid. See *infra* note 27.

[27] Directive on Takeover Bids as adopted ou 16 December 2003 (see also www.europarl.eu.int/plenary/default_en.htm); Commission Communication COM(2002) 534, based upon the *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids* (2002, available at europa.eu.iut). See also Joseph A. McCahery, Luc Renneboog, Peer Ritter and Sascha Haller, *The Economics of the Proposed European Takeover Directive* (Working Paper 2003, availahle at ceps.be).

There are two basic models. The first allocates decision-making wholly to the shareholders and sidelines target management as decision-takers.[28] In this model, the ability of the directors of the target to engage in self-interested behavior is severely consttained. In effect, the target shareholder/management agency problem is resolved by terminating the agency relationship for this class of decision: the principal is protected by becoming the decision-maker. Allocating decision-making in this way does nothing, however, to address the acquirer/target shareholder agency problem which must therefore be addressed in a separate set of legal strategies.[29]

Under the second model, target management is allocated a decision-making role in relation to the bid, not to the exclusion of but in addition to the shareholders. In effect, without the consent of the target hoard the offer cannot be put to the shareholders, though, equally, without the consent of the shareholders, the bid cannot succeed. There is in this situation a donble veto over the decision. Under this model, there is the potential for the directors, a small group, to deal with tbe acquirer on behalf of the dispersed shareholders in such a way as to mitigate the shareholders' secoud agency problem (and indeed the agency problems of non-shareholder stakeholders). Equally obviously, under this model there is greater potential for the directors to engage in self-interested behavior.[30]

The contrast between the two models is exemplified in a comparison of the UK and the U.S. rules. In both these jurisdictions the listed company with dispersed shareholdings is the typical situation, and thus the impact of the choice between the models is in practice highly significant.[31] Despite the commonality of the issue, the UK and the U.S. have made almost diametrically opposed choices, the UK following the exclusively shareholder decision-making model (at least in the post-bid period) and the U.S. that of the joint veto of management and shareholders. By conrrast, the current tendency in European countries with typically concentrated shareholdings—with the exception of Germany—is to adopt the first model.[32]

7.2.2 The first model: Non-frustration of the offer

Since a control transaction, as we have defined it, consists of an offer by an acquirer to purchase the shares of the target company shareholders, it might be thought to follow naturally, and without regulatory effort, that the decision on

[28] This is not to say that management is unable to influence the shareholders' decision.

[29] For a general discussion of decision rights and other strategies, see *supra* 2.2.

[30] Luciau Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 UNIVERSITY OF CHICAGO LAW REVIEW 973 (2002).

[31] With concentrated shareholdings, the target board will have less room for independent maneuver and the dominant principal/agent problem is that berween controlling shareholder(s) plus acquirer and minority shareholders. See *infra* 7.4.

[32] The Directive on Takeover Bids reflects the first model, but Member states may (1) opt out; and (2) permit companies that choose to opt in not to be bound vis-à-vis bidders that have not done so (reciprocity).

the success or failure of the bid will be taken solely by those shareholders. Certainly, it must follow that the target shareholders are in a position to veto the offer by refusing to accept it. However, this statement assumes the offer is open to the shareholders, an assumption that may be falsified to the extent that the hoard of the target is free to engage in defensive tactics which *de facto* discourage the acquirer from putting an offer to the shareholders or from persisting with an offer which has been made. These steps may take a myriad of forms but the main categories are: placing a block of the target's securities in the hands of persons not likely to accept a hostile bid; structuring the rights of the shareholders and creditors, for example, through poison pills; and placing strategic assets outside the reach of even a successful bidder.

The common and crucial consequence of these actions on the part of management is that a bid which does not have the support of the incumbent board will have no, or a significantly reduced, chance of success. In short, effectively to implement a strategy of exclusive shareholder decision-making in relation to public offers 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: the law must provide entry rules for acquirers as well as exit rules for shareholders. Thus, in the first model, the affiliation rights strategy is placed at the centre of regulation. However, as we shall see below, the implementation of this strategy turns mainly on the allocation of decision rights, in particular upon the requirement for shareholder approval of moves on the part of management which might impede an actual or poteutial offeror from putting an offer to the shareholders or deter the shareholders from accepting it.

It is important to note that the first model, allocating the decision on the offer solely to shareholders of the target, does not amount to a 'passivity rule' (at least in the strong sense of this term). Incumbent management remains free to persuade shareholders to exercise their right of choice in a particular way and, indeed, is normally required by the takeover rules to provide the shareholders with an opinion on the offer.[33] Incumbent management may also enlarge the shareholders' choice, for example, by seeking a white knight; and even appeal to the competition authorities to block the bid.[34]

Nor is the model of exclusive shareholder decision-making thought to be inconsistent with the operation of rules giving management advance warning that a potential acquirer is building a stake in the company. Most jurisdictions now have rules requiring the beneficial holders of shares in listed companies to disclose that fact to the company and the market when certain minimum levels are exceeded.[35] Although mainly developed for market transparency reasons,

[33] See *infra* 7.3.1.

[34] Presnmably the rationale is that this is an efficient way of keeping the public anthorities informed abont potential competition concerns.

[35] The Transparency Directive reqnires disclosnre at tbe 10% level (Art. 4, [1988] OJ L 348/62), but uational laws generally opt for 5%. See for France, Art. L. 233–7 Code de commerce; for Germauy, §21 Werrpapierhandelsgesetz. The UK has chosen the lower figure of 3% (§200 Companies

such rules do operate so as to give the management of potential target companies warning that a stake is being built up which may be a prelude to a bid. The beneficial owner may also be required to disclose, not just the fact of the ownership, but also its intentions in relation to control of the company.[36] Some jurisdictions employ a further technique and permit the *company* to trigger a disclosure obligation.[37] Provided there are effective controls over defensive tactics, there seems to be no policy reason to produce regulation which facilitates the target board being caught by surprise when an offer is made.

More controversial has been the freedom under the first model of the target board to seek out a 'white knight' which will put a competing offer before the shareholders, and perhaps one preferred by the target management. Although such action would seem to expand rather than restrict shareholder choice, it can be argued that the risk of a competitor means that some first bids will not be made at all and thus the overall number of bids is reduced. By contrast, a passivity rule would increase the number of bids and thus overall shareholder wealth.[38]

As noted, the first model for regulating control transactions is closely approximated in the UK, in particular by General Principle 7 of the City Code.[39] This prohibits any action to be taken by the board of the offeree company in relation of the affairs of the offeree company, without the approval of the shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits.[40] Thus, management cannot act unilaterally to defeat a bidder. The rule does not prohibit corporate action which has a frustrating effect, but it does require that such action be approved by the shareholders at a general meeting and, crucially, that that approval be given in the face of the bid. If the shareholders approve the frustrating action, they *ipso facto* reject the offer.

Act) and applies the rule to all public companies, not just to listed ones. Outside the EU, Switzerland has opted for 5% (Art. 20 Loi sur les bourses), as have the U.S. (§13(d) and (g) 1934 Securities Exchange Act and Rules 13d-1 to 13d-7, inserted by the Williams Act in 1968) and Japan (Art. 27–23(1) Securities and Exchange Act).

[36] See, e.g., in France Art. 1 Règlement COB 88–02 (but only at the 10% and 20% levels); in the U.S. §13(d) 1934 Securities Exchange Act (operating at the 5% level); in Japan Art. 27–23(1) Securities and Exchange Act (same).

[37] In the UK (§212 Companies Act), the company can require any shareholder or suspected shareholder to disclose the extent, if any, of its beneficial ownership of the company's shares. The disclosure obligation is not confined to the 3 or 5% threshold, but operates at any level of shareholding. The registrars of suspected target companies engage in regular programs of issuing '§212' notices to suspected stake-builders. In France, a similar result is achieved by permitting companies to impose disclosure thresholds in their articles of incorporation, additional to those in the statute, down to the 0.5% level (Art. L. 233–7 Code de commerce).

[38] Competing bids, including inducement fees, are discussed in more detail *infra* 7.3.4.

[39] Fleshed out in greater detail in Rule 21 City Code.

[40] General Principle 7 is particularly strongly formulated. It is an effects-base rule, so that proof that the action proposed was intended to, and would in fact, advance the shareholders' interest does not avoid the application of the rule.

It has often been pointed out that a major weakness of the first model is that the requirement of shareholder approval of defensive tactics applies only once a bid is in contemplation,[41] even though management may well be able to act effectively against potential offers in advance of any particular offer materializing. However, to apply a pre-bid requirement of shareholder approval, at least on the basis of an 'effects' test, would be too great an interference with the operation of centralized management.[42] Any commercial decision which might have the effect of deterring a future bidder for the company would have to be put to the shareholders for their approval. However, pre-bid defensive tactics, if not controlled on an 'effects' basis, are subject to other legal strategies identified earlier in this book (Table 2-1).[43] Thus, fiduciary standards may apply to board decisions pre-bid to introduce defensive measures (when the main purpose is to entrench management), and the rules on significant transactions may require shareholder approval of certain types of pre-bid defensive tactic.[44] Moreover, in European jurisdictions there has been a tendency in recent years simply to prohibit certain measures whose defensive potential is high where there is no strong apparent legitimate argument for the measures, such as voting caps[45] and cross-shareholdings.[46] Equally, stock exchange rules outlaw a traditional defensive tactic, the requirement of directorial approval for share transfers.[47]

Nevertheless, it is difficult to assess the overall effectiveness of this *mélange* of obstacles to pre-bid defenses and it must be conceded that requirement for

[41] See Paul Davies, *The Regulation of Defensive Tactics in the United Kingdom and the United States*, in Hopt and Wymeersch, *supra* note 2, 195.

[42] See, e.g., General Principle 7 City Code (UK) and §12 Ubernahmegesetz (Austria): the non-frustration rule is triggered once the board of the target in fact knows an offer is probable, whether it has been announced formally or not.

[43] See *supra* 2.2. Surveys of pre-bid defensive measures and their control by company law can be found in J.M.M. Maeijer and Koen Geens (eds.), DEFENSIVE MEASURES AGAINST HOSTILE TAKEOVERS IN THE COMMON MARKET (1990)—now somewhat dated—and in Arnd Weisner, VERTEIDIGUNGSMAßNAHMEN GEGEN UNFREUNDLICHE ÜBERNAHMEVERSUCHE IN DEN USA, DEUTSCHLAND UND NACH EUROPÄISCHEM RECHT (2000). There is a comprehensive list of barriers to takeovers in Annex 4 of the High Level Group Report (*supra* note 27).

[44] See *supra* 6.2.1. On the effect of such rules in discouraging poison pills in European jurisdictions, see *infra* note 53.

[45] See *supra* 3.2.1. Voting caps were popular in Germany but are no longer available to listed AGs under an amendment to §134 I Aktiengesetz made in 1998. In France the general company law explicitly authorizes voting caps (Art. L. 225–125 Code de commerce), but the COB regards them as objectionable in a takeover context and some companies have altered their rules so as to make them inoperative if half or more of the capital is acquired by the same person. The same result is mandated in Italy by Art. 212 Legislative decree 58: Guido Ferrarini, *Share Ownership, Takeover Law and the Contestability of Corporate Control*, in Conference Proceedings, COMPANY LAW REFORM IN OECD COUNTRIES, A COMPARATIVE OUTLOOK OF CURRENT TRENDS (available on www.oecd.org/dataoecd/8/27/1931676.pdf).

[46] Art. L. 233–29 Code de commerce (France); Art. 121(1) Legislative decree 58 (Italy); Art. 241(3)(4) Commercial Code (Japan). However, circular holdings are normally permitted, so that the restriction on cross-holdings is only partially effective. On the other hand, changes outside company law may encourage the dismantling of cross- and circular holdings, such as recent changes in capital gains tax on share disposals in Germany.

[47] For the EU, see Art. 46 Listing and Regular Information Directive, [2001] OJ L 184/1 (shares must be freely negotiable).

shareholder approval post-bid, coupled with more relaxed pre-bid controls, gives the board some incentive to take defensive actions pre-bid. Probably, pre-bid controls are most effective when reinforced by shareholder pressure against pre-bid defensive tactics, as in the long-standing opposition of UK institutional shareholders to the (perfectly lawful) issuance of non- or weighted-voting shares by publicly traded companies.[48]

7.2.3 The second model: Directors controlling access to the shareholders

Under the second model, the success of an attempt to shift control of a company by offers to purchase the shares of the company depends on the approval of the board of directors as well as of a sufficient proportion of the shareholders. If the first model turns on the allocation of the decision whether to accept the offer solely to the shareholders, the pivotal point in the second model is joint decision-making. Decision-making on a control transaction occurs in a way which is similar to that discussed in the previous chapter in relation to significant transactions, that is, jointly by board and shareholders.[49] The second model gives greater recognition to the corporate consequences of a control shift by requiring a corporate decision (taken by the management) on whether the offer shall proceed. The shareholder decision—whether to accept an offer which surmounts the hurdle of management approval—is then normally taken individually, rather than at a meeting. However, as we shall see, this joint decision-making model may give the shareholders an incentive to use their (corporate) appointment rights over the board so as to produce a senior management which will take the appropriate decision (from the shareholders' point of view) over any bid which may be in prospect.

As far as the board element in this decision-making process is concerned, the legal strategies which are typically deployed to address the shareholder/management agency problems are those which we discussed in relation to board decision-making in general, for example, fiduciary duties or reward strategies.[50] Under this second model, special legal strategies for control transactions are not called for, at least in relation to the decision by the board whether to facilitate the offer. However, those general company law strategies have to be applied in a new context. Thus, 'golden parachutes' and other reward devices for aligning board and shareholder interests are likely to be welcomed. By contrast, under the first model, where the board is sidelined, alignment of the board's interests is in principle not an issue and golden parachutes, especially those negotiated post-bid, tend to be treated with suspicion.[51]

[48] Davies, *supra* note 41. [49] See *supra* 6.2.1. [50] See *supra* 3.1.2.

[51] Compare Romano, *supra* note 2 (golden parachutes benefit shareholders by aligning managers' incentives with the shareholders' interest, as managers are financially rewarded for approving a takeover); David Scharfstein, *The Disciplinary Role of Takeovers*, 55 Review of Economic Studies 185 (1988) (even an optimal contract is generally inefficient); with §§314–316 Companies Act (UK) (requiring shareholder approval for payments made to directors by way of compensation for loss of office in the wake of takeovers), and the prohibition on such payments in §33(3) Übernahmegesetz (Germany).

The closest approximation to this second model in practice is to be found in those state jurisdictions in the U.S. which are favorable towards the use of 'poison pills' as takeover defenses. The essence of the poison pill is that the crossing by an acquirer of a relatively low threshold of ownership triggers rights for target shareholders in relation to the shares of either the target or the acquirer, from which the acquirer itself is excluded and which render the acquisition of further shares in the target fruitless or impossibly expensive.[52] The success of the defense depends upon the management having power under the general company law and the company's constitution to adopt the plan containing these contingent rights without the approval of the shareholders[53] and upon the courts' holding it not to be a breach of the directors' duties to refuse to remove the plan in the face of a bid. Whilst the poison pill is not mandatory, the ease with which it can be adopted by management of potential target companies renders it widespread in practice in U.S. companies.

However, it would be wrong to see the second model as exclusively exemplified by the United States. Within Europe, the controversy about defensive measures can be seen as revolving around a conflict between the first model (non-frustration) and a system of rules which straddles the two models, whereby the management may be permitted to adopt defensive measures but through mechanisms less demanding than shareholder approval in the face of a bid.[54] Thus, under §33(2) *Übernahmegesetz* (Germany) shareholders are permitted to authorize directors to take specified types of defensive measure through resolutions adopted *in advance of* the hostile offer. Such permission may be given for periods of up to 18 months by resolutions requiring the approval of three-quarters of the shareholders, though the constitution of a particular company may set more demanding rules. This is a significant qualification of the affiliation strategy. In addition, under §33(1) the supervisory board may authorize management in the face of the bid to take defensive measures. This involves using a trusteeship,[55] rather than a decision-rights, strategy to address defensive measures and its effectiveness (from the shareholders' point of view) depends heavily on the ability of the supervisory boatd to play a genuinely independent role.[56]

[52] This definition of a poison pill is taken from Lucian A. Bebchuk and Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 Columbia Law Review 1168 (1999) (citing, in their footnote 35, the chief economist for the Securities and Exchange Commission). See also, by the same authors, *On Takeover Law and Regulatory Competition*, 57 The Business Lawyer 1047 (2002).

[53] For this reason the poison pill is not an available defense in many European countries where the Second Company Law Directive [1977] OJ L 26/1, requires shareholder approval for increases in capital (Art. 25). See in general Ferrarini, *supra* note 45.

[54] It was the failure to move away from the first model towards this hybrid version which caused the collapse of the proposal for an EU directive in 2001. See Rolf Skog, *The Takeover Directive—An Endless Saga?*, 13 European Business Law Review 301 (2002). Compare the compromise solution of the Takeover Bids Directive, *supra* notes 27 and 32.

[55] See *supra* 2.2.2.3.

[56] For an assessment of supervisory boards in two-tier board structures, see *supra* 3.1.1.1. The German legislator's attachment to the role of the supervisory board is indicated by the requirement that even measures of a type authorized in advance by the shareholders must also be approved by the supervisory board on the occasion of their exercise: §33(2) Übernahmegesetz.

Nevertheless, the first model seems to be the predominant one in recent European takeover regulation.[57] This is the case in Austria, Italy, Portugal, and Switzerland.[58] As for the earlier sets of rules, the City Code in the UK has contained such a rule since it was introduced in 1968; and in France the requirement of the relevant regulator, the *Commission des Opérations de Bourse* (COB), seems to be interpreted so as to produce a no-frustration obligation.[59] However, some countries, notably the Netherlands, have long been in the camp of those adopting the second model.[60]

Japan has a system of rules which is difficult to characterize because of its inchoate state. Japanese company law[61] is silent (or undeveloped) about hostile takeovers, probably because very few have ever been attempted and none has succeeded. However, recent reforms may facilitate the adoption of defensive measures should a hostile bid occur.[62] First, the board can now repurchase an unlimited number of shares, provided it is authorized to do so by the shareholder meeting or by a charter provision. Whether the board may repurchase shares for the sole purpose of defeating a takeover attempt remains controversial and will need judicial interpretation. Second, the board has also been empowered to issue stock options without having to seek shareholder approval. Here again, whether stock options can serve as poison pills remains unclear, not least because courts may prevent 'unfair' issuances.[63] Third, the company charter may now widely provide for special classes of shares, which may permit the adoption of shark repellent provisions—for example, requiring the approval of a given class for the election of directors.[64]

7.2.4 Rationales for the second model

There are two possible rationales for the second model of decision-making. The first is that the board of the target is given a veto over the proposed control shift

[57] For a general overview, see Klaus J. Hopt, *The Duties of the Directors of the Target Company in Hostile Takeovers—German and European Perspectives*, in Guido Ferrarini, Klaus J. Hopt and Eddy Wymeersch (eds.) CAPITAL MARKETS IN THE AGE OF THE EURO 391 (2002).

[58] §12 Übernahmegesetz (Austria); Art. 102 Legislative decree 58 (Italy); Art. 182 Securities Code (Portugal); Art. 29 Loi sur les bourses (Switzerland).

[59] Art. 4 Règlement COB seems to require only disclosure of defensive measures to the COB and gives that body the power to express its view. Alain Viandier, OPA, OPE ET AUTRES OFFRES PUBLIQUES 350 (1999) describes this rule as analogous to the non-frustration rule of the Swiss law (see previous note).

[60] Steven R. Schuit and Jan-Erik Janssen, M & A IN THE NETHERLANDS 124 *et seq.* (1996). But even there the usefulness and legal permissibility of such techniques have been questioned: Levinus Timmerman, *Das niederländische Gesellschaftsrecht im Umbruch in* Uwe H. Schneider, Peter Hommelhoff, Karsten Schmidt, Wolfram Timm, Barbara Grunewald and Tim Drygala (eds.), FESTSCHRIFT FÜR MARCUS LUTTER ZUM 70. GEBURTSTAG 173, 175 (2000).

[61] The Japanese Securities and Exchange Act submits reporting companies (as defined in note 8 *supra*) to stock tender offer rules similar to those of the U.S. 1934 Securities Exchange Act but for a partial mandatory bid rule. See *infra* note 93.

[62] Note that the reforms were not specifically aiming at hostile takeovers, their purpose being to generally deregulate corporate law. Thus, there is some uncertainty about the validity of defensive measures.

[63] Art. 280-39(4) and 280-10 Commercial Code.

[64] Art 222(9) Commercial Code.

in order to protect the shareholders of the target against opportunistic conduct on the part of the acquirer. However, if the contribution of the board to the reduction of the costs of the second agency problem (acquirer and target shareholders) is to be realized in practice, regulation must ensure that the broad veto power conferred upon incumbent management is used to defeat only opportunistic bids and not simply to promote management entrenchment. In terms of legal strategies to achieve this result, the obvious one is *ex post* review by the courts. It has been argued[65] that in the 1980s the Delaware courts applied fiduciary duties to directors in such a way as indeed to sustain refusals to redeem pills only where the bid was formulated abusively as against the target shareholders. At this time, therefore, it could be argued that the poison pill was generating an efficient set of responses to the twin agency problems of the target shareholders: directors could exercise their discretion to block the opportunism of acquirers but not to further their own interests in the preservation of their jobs.

However, with the development by the Delaware courts of the 'just say no' rule, the impact of the poison pill changed dramatically. The starting point of this new approach was that deciding on the fate of a bid is 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 the board remit.[66] Sole decision-making had to be given to the shareholders (and indeed a policy of neutrality adopted among the competing bidders) only if the incumbent management had reached a decision to sell control of the company or to dispose of its assets.[67] But the decision to maintain the business as a going concern in the hands of the incumbent management was one that the board was in principle free to take, whether or not it thought the offer to be wealth maximizing from the shareholders' point of view. Thus, the rationale of the second model becomes the protection of the business strategy of the incumbent management (and possibly by extension the interests of non-shareholders) rather than the protection of the shareholders of the target.

Although this broadening of the directors' discretion as to the use of their veto power, brought about by the 'just say no' rule, does not completely rule out a direct approach to the shareholders, it does significantly improve the board's defensive position. In response to the poison pill, the acquirer may couple (or precede) an offer addressed directly to the shareholders of the target with a proxy solicitation for the removal of the incumbent management.[68] In short, the focus of attention shifts from a decision on the offer to a decision on the

[65] *Supra* note 52, at 1184–8.

[66] *Paramount Communications Inc.* v. *Time Inc.*, 571 ATLANTIC REPORTER SECOND SERIES (hereafter A 2d) 1140 (1989); *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (1985); *Unitrin Inc.* v. *American General Corporation*, 651 A 2d 1361 (1995).

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

[68] See Marcel Kahan, *Jurisprudential and Transactional Developments in Takeovers*, in Klaus J. Hopt, Hideki Kanda, Mark J. Roe, Eddy Wymeersch and Stefan Prigge (eds.), COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 683 (1998).

re-appointment of the board.[69] In this way the shareholders ultimately get to decide on the issue in general meeting, i.e., through a corporate decision. However, there is the crucial difference that the burden of action is on the offeror rather than the incumbent board, and the time involved in organizing a proxy contest may be considerable (perhaps extendiug over a couple of years if there is a staggeted board). Thus, the process of acquisition is slowed down considerably, the incumbent board has a greater opportunity to organize its defense, the risk of the emergence of a competing bidder is increased and, in general, the incentives for the acquirer to do a deal with the incumbent board are enhanced.[70]

7.2.5 Comparing the two models

It seems very difficult to justify the current Delaware version of the second model on the grounds that it efficiently addresses the twin agency prohlems of shareholders of target companies. On the contrary, 'just say no' appears to provide considerable scope for managerial entrenchment and thus constitutes an approach which exacerbates the first agency problem of the shareholders.[71] It is doubtful whether the stress placed by the courts on the support of the independent directors for the management's strategy substantially qualifies this assessment.[72] Thus, the City Code and current Delaware law constitute strongly contrasting approaches to the regulation of control transactions. Apart from being a timely reminder that 'Anglo-American' company law is not the unity that is sometimes assumed, the contrast between the first model and the second (at least when the latter is interpreted on a 'jnst say no' basis) goes to the heart of the controversy about the regulation of control transactions.

On the first model, regulation facilitates the core feature of company law, which we identified in Chapter 1 as the free transferability of shares.[73] On the selling (or transferring) side the existing shareholders of the target company are allocated exclusively the decision whether to accept the offer. The board (agent) has little or no say in whether the shareholders (principal) continue or terminate

[69] Assuming that the 'dead-hand' poison pill, which restricts redemption of the pill to the board which adopted it, continues to be unacceptable under the fiduciary standards applied iu Delaware: *Quickturn Design Systems Inc* v. *Shapiro*, 721 A 2d 1281 (1998).

[70] On the advantages of the bid over a proxy fight see Louis Loss and Joel Seligman, FUNDAMENTALS OF SECURITIES REGULATION 562 (4th ed. 2001). Lucian Bebchuk and Oliver Hart, *Takeover bids versus proxy fights in contests for corporate control* (Working Paper 2001, available at cepr.org) have argued that in principle a speedy shareholder vote binding on all the shareholders is preferable to individnal acceptances of a general offer as a way of deciding npon a bid, though they recognize that the American rules fall short of this scheme and, indeed, argue that the City Code non-frustration rule comes closer to it. See also Lucian A. Bebchuk and Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VIRGINIA LAW REVIEW 111 (2001). As to ways of dealing with the problems caused by the absence of a corporate decision, see text attached to *infra* uotes 82–83.

[71] Cf. Marcel Kahan and Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Takeover Law and Adaptive Behavior*, 69 UNIVERSITY OF CHICAGO LAW REVIEW 871 (2002) (market participants neither tried to change the law or to opt out of it).

[72] Kahan, *supra* note 71, 685.

[73] *Supra* 1.2.3.

the agency relationship between them. Such a set of rules not only facilitates the transfer of corporate assets to the highest value user, but the threat of a bid provides a low-cost (to shareholders) incentive to the board to keep rhe interests of the shareholders centre-stage even when no bid is imminent. On this view, setting exit terms for shareholders and entry terms for acquirers is a more effective way of dealing with the general shareholders/directors agency problem than are appointment rights or agent constraints through rules and standards.

Under the second model, at least under the 'just say no' rule, centralized management becomes a good in itself and is to be protected from being undermined by control transactions effected between acquirers and target shareholders. A change in the target's business strategy is a common result of a successful acquisition and, for this reason, the board should be involved in decision-making on the control transaction. This conclusion is reflected in analogous parts of company law, such as the statutory merger procedure: shareholders will typically not get to consider the merger unless it is proposed by the directors.

As we suggested in Chapter 3,[74] it seems likely that the contrast between the City Code and current Delaware law is not specific to coutrol transactions but vividly reflects a more general contrast between English and U.S. law on the role of centralized management. English law has always viewed the powers of the board as flowing from a delegation from the shareholders who consequently control, through the company's constitution, the extent of that delegation. U.S. law has taken a more prescriptive approach to centralized management, with the powers of the board flowing, in part at least, directly from the statute rather than from delegation by the shareholders. In the area of control transactions, the difference seems not to be just a doctrinal one but to have significant consequences in practice. Thus, although the U.S. economy is six times the size of the British one, in the 1990s it generated only twice as many hostile bids.[75]

7.3 AGENCY PROBLEMS OF DISPERSED SHAREHOLDERS WHEN A GENERAL OFFER IS MADE

No matter to which of the above models any set of rules dealing with control transactions approximates, offers will be made to shareholders of target companies to acquire their shares. Under systems approximating to the first model, the objective is indeed to facilitate the making of such offers, but even under systems approximating to the second model offers will be made where the acquirer can obtain the support of the incumbent management or thinks it can

[74] *Supra* 3.1.2.6. See also *supra* 6.2.1.1.

[75] Christian Kirchner and Richard W. Painter, *European Takeover Law—Towards a European Modified Business Judgment Rule for Takeover Law*, 2 EUROPEAN BUSINESS ORGANISATION LAW REVIEW 353, 377 *et seq.* (2000). Although there might he other reasons for this discrepancy, differences in shareholder structure or structural barriers to takeovers are unlikely to explain this U.S./UK contrast.

evade the target board's defensive moves. Once the offer is made, the shareholders of the target may thus face agency problems as against both the acquirer (who will want to pressurize the shareholders into accepting the offer) and possibly the incumbent management. The latter may wish to persuade the shareholders of the target to reject an offer which is wealth maximizing for the shareholders but threatens the jobs of the incumbent management or to accept an offer which is not wealth maximizing for the shareholders but preserves management jobs.

Borh sets of risks obviously arise under the first model of regulation, but are also a possibility under the second. However, whereas the first model makes it clear that target shareholders cannot rely on target management to protect them against opportunistic behavior on the part of the acquirer, so that the need for specific regulation of acquirer behavior is clearly flagged, the second model is premised upon the ability and willingness of target management to perform that role. Thus, in systems based on the second model, regulation specifically targeted at acquirer behavior tends to be less developed, as is the case in the United States.

We now turn ro examine the legal strategies which are deployed once it is clear that an offer will be made to the shareholders. Before we do so, we need to note that all the techniques to be discussed have costs, in particular regarding the number of control transactions which occur.

7.3.1 Information asymmetry: The affiliation strategy

Under the hypothesis we are now considering, the decision on the bid is with the shareholders, either because the law places it there (under the first model) or because the directors have allowed the bid to go forward (under the second). In order to take that decision the shareholders need to be properly informed. However, does the law need to stipulate what information shall be made available? Even without regulation, the target management and the acquirer are likely to genetate a lot of information about both companies—and, in a hostile bid, to point out the weaknesses in each other's presentations. However, both sides are under strong incentives to hide unfavorable, and to exaggerate favorable, information.

A target board which succeeds in fending off a bid may subsequently come to regret verbal hostages to fortune given in the heat of battle, as may a successful bidder, but anticipation of such problems is unlikely to outweigh the immediate imperatives of winning the contest. By controlling the types of information which can be distributed and the channels by which it is disseminated, such regulation may discourage unsubstantiated and unverifiable claims.

In an agreed bid, these incentives for reciprocal criticism will be lacking, especially for management buy-outs (MBOs), where the management of bidder and target is common. Here, mandatory disclosure requirements can help the process by providing the materials on the basis of which gatekeepers such as investment bankers can evaluate the bid.

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 disclosure obligations applied to listed companies in most jurisdictions,[76] 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 to discover that a centerpiece of all takeover regulation, whether it is based on the first model or the second, is 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. Even if the regulation does little else (the federal securities laws in the United Srates[77] being an example), it will tackle the issue of information disclosure.

It might be argued that the shareholders do not primarily need disclosure of information, but rather some overall assessment of the fairness of the offer. The City Code attempts to meet this need by requiring the offeree to obtain 'competent independent advice' on the merits of the offer (usually from an investment bank) and to make it known to the shareholders. Not surprisingly, supervisory authorities tend to shy away from giving opinions on fairness ('merit regulation'). However, in France, the CMF can require the offeror to review the proposed offer on the grounds that the price or exchange offered is not acceptable 'on the basis of customary and objective evaluation criteria and the nature of the target company.'[78] This unusual power may be a reflection of the overt role previously played by the French state in the regulation of takeovers.[79]

Information disclosure is particularly important in the case of management buy-outs. Here the management is also (part of) the offeror and, in the absence of regulation, the shareholders may be presented with only one view of the deal. In this context, general rules requiring the board of the target to take independent advice on the merits of the bid and to publish it or not to favor their own offer over competing bids acquire a particular importance. Thus, where an MBO is on the table, the City Code stresses the need for independence in the advice provided to the board and requires that all the information given to (potential) external providers of finance must also be given to a competing bidder.[80] In jurisdictions without takeover specific regulation on the matter, it

[76] For the EU, see Art. 68 Listing and Regular Information Directive. On the problems of instant disclosure, see Klaus J. Hopt, INSIDER REGULATION AND TIMELY DISCLOSURE 10 *et seq.* (1996).

[77] *Cf. Schreiber* v. *Burlington Northern Inc.*, 472 U.S. REPORTS 1 (1985) (denying any larger aim to the Williams Act reforms).

[78] Art. 5-1-9 Règlement Général CMF. [79] Viandier, *supra* note 59, 32.

[80] Rule 3.1 (Note 1) and Rule 20.2 (Note 3).

may be possible to leave the issue to general corporate law, notably the rules on self-dealing transactions.[81]

A final general aspect of information rules in takeover bids is acceptance of the view that information disclosure is ineffective unless shareholders are given enough time to absorb the information (or other people's analyses of the information) before they have to act on it. All 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. The main counter argument 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. In addition, mandatory minimum offer periods increase the chances of 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.[82]

7.3.2 Pressure to accept the offer: The reward strategy

Information disclosure seems a universal attribute of laws on control transactions, probably because even those based on the second model (board-controlled bid) suppose that the shareholders will and should take an independent view on the merits of any offer which is put to them. However, there is a discernible contrast between the two models when it comes to controlling the more sophisticated forms of acquirer opportunism. Systems based on the first model (sidelined target management) have to erect a regulatory structure to deal with such opportunism; systems based on the second model can co-opt target management to that end and may put in place less thorough regulatory structures (though they do not ignore the problem of bidder opportunism entirely). The central question is how rigorously any particular system implements the principle of equality of treatment among target shareholders. Equality of treatment is not here the expression of a misplaced conversion on the part of company law to the dictates of distributional equality, but rather constitutes the principle which stands in the way of acquirers which wish to put illegitimate pressure on target shareholders to accept the offer.[83]

All systems recognize the value of equality of treatment to some degree. Thus, disclosure rules bring about greater equality of information among target shareholders. Rigorous implementation of the equality principle, however, goes well

[81] See Werner F. Ebke, *The Regulation of Management Buyouts in American Law: A European Perspective*, in Hopt and Wymeersch, *supra* note 2, 295, 304–306—though it should be noted that the transaction here is technically one between the director (or associated person) and the shareholders, not the company.

[82] See the discussion of the passivity rule, *supra* 7.2.2.

[83] Paul Davies, *The Notion of Equality in European Takeover Regulation*, in Jennifer Payne (ed.), TAKEOVERS IN ENGLISH AND GERMAN LAW 9 (2002).

beyond this. Must all offerees receive the same offer, so that two-tier bids are prohibited? Must those who accept offers be treated equally with those who have sold their shares to the acquirer outside the formal offer? Should partial offers be allowed? And, most controversial of all, should persons who have acquired certain percentages of a company's voting shares be required to offer for the remainder and at what price?

An obvious source of pressure to tender is the acquirer's contractual freedom to formulate the offer as it wishes. The general technique is to offer a high price to some shareholders in order to gain *de facto* control and thus to put pressure on the remaining shareholders to accept a lesser offer (even the lesser offer is better than being locked into a non-controlling position with the acquirer in charge). Although two-tier offers do not offend the provisions of the Williams Act in the U.S., they are in effect outlawed in Europe and Japan, either through provisions giving regulatory bodies discretion over the approval of the form of offers or by explicit provisions requiring the same offer to be made to all shareholders.

Alternatively, instead of formulating differential offers, the acquirer may seek to offer some target shareholders 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 the offer period.[84] An alternative strategy is to require the offer price to be raised to the level of the out-of-bid purchases. Where such purchases are permitted during the offer period, the imposition of a sharing rule (which raises the offer price to the level paid outside the offer) seems universal. More difficult is the issue of whether pre-bid purchases should be subject to a sharing rule. Practice across Europe varies somewhat, but both the UK and Germany impose a strict sharing rule on recent pre-bid purchases.[85]

However, as Bebchuk has demonstrated, pressure to tender can be generated without breaching the equality principle in the formulation of the offer or by making purchases at a higher price outside the offer. Shareholders may still come under pressure to accept a uniform offer, which they regard as less than optimal and therefore wish to reject, for fear of being locked into the target as minority shareholders if the majority of the shareholders take a different view.[86] However, the solution to this problem is relatively simple, namely, the extension of the limit for acceptance of the offer to embrace a short period after it has become

[84] Rule 10b-17 1934 Securities Exchange Act (U.S.); Art. 5-2-12 Règlement Général CMF (France). The latter prohibits market purchases of the target shares during the offer period, but in share exchange offers only, presumably on the grounds that the offerees are not receiving cash.

[85] Rules 6 and 11 City Code (UK) (but requiring cash only where the pre-bid purchases for cash reach 10% of the class in question over the previous 12 months); §31 Übernahmegesetz and §4 Übernahmegesetz-Angebotsverordnung (Germany) (requiring cash at the 5% level but only where that percentage was acquired for cash in the 3 months prior to the bid).

[86] Lucian A. Bebchuk, *Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DELAWARE JOURNAL OF CORPORATE LAW 911 (1987). The argument is a version of the well-known 'prisoners dilemma'.

clear that a majority of the shareholders have accepted the offer.[87] In other words, a dissenting shareholder is given the opportunity to change his or her mind in favour of the offer once the crucial piece of information previously lacking—the decision of the majority of the other shareholders—has been provided.

However, this rule is relatively rare. More common, in continental Europe, is the less effective strategy of relying on minimum offer periods plus frequent announcements by the bidder during the offer period about the progress of the offer, whilst reserving compulsory purchase rights for the shareholders as against the acquirer to situations where the bid results in the acquirer having 90% or more of the target's shares.[88] In the U.S., controls over the bidder's subsequent dealings with the new subsidiary perform a similar role. Such rules are a common feature of 'second generation' state anti-takeover statutes.[89]

7.3.3 The mandatory bid rule: The exit strategy[90]

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 by private contract (whether on or off market) to obtain control of the target and that the offer be at the price highest paid for the controlling shares. This is the mandatory bid rule. Here the law, in imposing a duty on the acquirer to make a general offer, goes so far as to give the shareholders something they rarely have, namely, a right to exit the company and at an attractive price. The mandatory bid rule does not simply structure a bid the acquirer wishes in principle to make, but requires a bid in a situation where the bidder might prefer not to make one at all.

Such a requirement might be justified on two grounds. First, although the rule cannot be justified on the basis of pressure to accept a general offer (the assumption is that there would not be one in the absence of the rule), the absence of a mandatory bid rule would permit the acquirer to put pressure on those to whom private or market offers are made to purchase shares which will give the acquirer control. Absent a mandatory bid rule, acquirer is free to make the following statement: 'I offer you an attractive price for your shares. If you do not accept it now, you may lose the benefit of the offer and, in addition, find that your shares have declined in value because I will be prepared to make only a lower offer (or none at all) once I have obtained control of the company.' In a private purchase, this statement may be made explicitly; in market purchases,

[87] See, e.g., Rule 31.4 City Code (UK) (but qualified by Rule 33.2); §16(2) Übernahmegesetz (Germany).

[88] See, e.g., Art. 108 Legislative Decree 58 (Italy).

[89] For example, the requirement in some U.S. state laws that a fair price be paid to non-tendering shareholders who are subsequently squeezed out after a successful bid performs a similar, if less comprehensive, role (e.g., Maryland General Corporation Law, §§3-601 to 3-603).

[90] The additional issues arising when a mandatory bid rule is imposed on an offer for a company where there is an existing controlling shareholder are discussed *infra* 7.4.

implicitly. The rule prevents the acquirer from making a market raid which gives it control, albeit at the cost of driving up the market price, unless it is prepared to extend the offer generally. Such a rule also protects those shareholders who are not close to the market and who might not react in time to the opportunity afforded by the raid.

Second, it could be said that permitting the acquisition of control over the whole of the company's assets by purchasing only a proportion of the company's shares would encourage transfers of control to those likely to exploit the private benefits of corporate control rather than make the most efficient use of the corporate assets. On this view, the mandatory bid rule constitutes a pre-emptive strike at majority oppression of minority shareholders and proceeds on the basis that general corporate law is not adequate to police the behavior of controllers. The mandatory bid rules thus anticipates that there is a strong likelihood of majority/minority conflicts after the acquisition of control, and gives the minority the option to exit the company before such problems manifest themselves. On this rationale, the mandatory bid rule should be accompanied by a prohibition on partial offers, even by an acquirer who does not start from a controlling position. By extension, there should also be a rule requiring comparable offers to be made for all classes of equity share in the target, whether those classes carry voting rights or not.[91]

Mandatory bid rules are now quite widespread outside the U.S.,[92] even in Germany and Portugal, the two European countries that have a highly developed, statutory group law and where, therefore, there might be thought to be less need for a mandatory bid rule.[93] Mandatory bid rules display a number of common features. They are usually triggered by the acquisition of *de facto* control, identified as being around one third of the voting shares,[94] including the shares held by persons acting in concert with the acquirer. Intensification of a control position is generally embraced within the rule, though sometimes with an exception for *de minimis* additional acquisitions.[95] When the rule bites, it requires the acquirer to offer for all the outstanding shares of the

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

[92] Note that Japan uncharacteristically diverges from the U.S. in that securities regulation comprises a mandatory bid rule. See Art. 27-2(1) Securities and Exchange Act (purchase of more than one-third of voting shares). Even in the U.S. they are to be found in some states. See, e.g., §910 Pennsylvania Business Corporation Law, and §910 Maine Business Corporation Act.

[93] See §§35-39 Übernahmegesetz (Germany); Art. 187 Securities Code (Portugal). The traditional position that German group law is a substitute for a mandatory bid is still argued by Holger Altmeppen, *Neutralitätspflicht und Pflichtangebot nach dem neuen Übernahmerecht*, 2001 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 1073, 1082 *et seq.* Yet by now this is a clear minority view, though it could be argued that *ex ante* protection through the mandatory bid and *ex post* protection through group law is overly protective of shareholders.

[94] Though in Austria, a number of additional ways of demonstrating control are available: §22 Übernahmegesetz.

[95] Under a recent change the City Code, which has always included intensification of control within the mandatory bid rule, the *de minimis* yearly increase previously permitted (of 1%) has been removed. Significantly, this seems to have been a response to the failure of minority shareholders to

target.[96] Any lesser requirement would seem to defeat the protective purpose of the rule. Finally, the rule is usually subject to a number of exceptions, to allow for competing policies to be given priority, for example, where the threshold is breached as part of a rescue effort for a failing company.

Whilst these features of the rule effectively address the agency problems of target shareholders as against acquirers in the context of particular transactions, the mandatory bid rule runs the risk of reducing the number of control transactions which occur. This is so for two reasons. First, and more obviously, 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 or it does not offer for control at all.[97] The mandatory bid rule may also require the bidder to offer a cash alternative when otherwise it would have been free to make a wholly paper offer. Second, 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.

Some, but by no means all, takeover regimes have responded to these concerns, either in the formulation of the rules relating to the fixing of the price for the general offer or by extending the list of exceptions to the rule. Italian law automatically allows the offeror some protection against fluctuations in the market price of the target's shares by tempering the 'highest price' rule by reference to the average market price.[98] Swiss law goes even further by requiring only that the offer be at not less than the higher of the market price when the bid is made and 75% of the highest price paid for the shares over the previous 12 months.[99] By contrast, neither the German nor the UK rules make any but limited concessions about the application of the sharing rule, whilst France seems not to do so in practice.[100]

successfully invoke the general Companies Act unfair prejudice remedy after an acquirer moved over a number of years from 45% to 51% and then announced that it would use its *de jure* control to cease dividend payments: *Re Astec (BSR) plc* [1998] 2 Butterworths Company Law Cases 556.

[96] This is true for France (Art. 5-1-2 Règlement Général CMF), which prior to 1992 required only a partial bid.

[97] See, e.g., Clas Bergstrom, Peter Hogfeldt and Johan Molin, *The Optimality of the Mandatory Bid*, 13 Journal of Law, Economics and Organization 433 (1997). Note that, in some cases, the offer must also be made for non-voting shares.

[98] Art. 106(2) Legislative Decree 58 (Italy) (the offer must be at not less than the arithmetic mean of the highest price paid by the offeror in the previous 12 months and the average market price over that period).

[99] Art. 32(4) Loi sur les bourses (Switzerland).

[100] See §4 Übernahmegesetz-Angebotsverordnung (Germany); Rule 9.5 City Code UK) (but with a discretion in the Panel to dispense from the highest price requirement—note 3 to Rule 9.5). The French regulation stops short of a specific requirement of the highest price, but the CMF must judge the mandatory bid 'acceptable' (Viandier, *supra* note 59, 190). Compare Art. 5 of the 2003 Takeover Bids Directive (reflecting the German and UK rules) and the recommendations by the High Level Group, *supra* note 27 (the EU should harmonize on a 'strong presumption' in favor of the highest price rule, so that offerors could predict accurately the price they were likely to have to pay).

As to derogations, all systems contain them, for example, to deal with accidental crossing of the threshold. However, in some systems the legislator has clearly aimed to craft the mandatory bid rule so as to reduce its chilling effect on the number of control transactions. Thus, in Italy certain types of partial offer do not trigger the obligation to bid.[101] Again, Switzerland goes further by permitting 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% or to disapply the obligation entirely.[102] Of course, such provisions still leave the burden of proof on those arguing against the mandatory bid rule.

7.3.4 Competing bids

A competing bid can be seen as a procedural way of addressing the problems which target shareholders have in evaluating the offer made to them and avoiding pressure to tender. The wealth-enhancing impact of competing bids as far as target shareholders are concerned is well-established in the empirical literature.[103] Facilitating competing bids can be regarded as another example of the sharing strategy, this time, however, not as between shareholders accepting the offer and those selling outside the bid, but as between the acquirer and the target shareholders and relating this time to the gains to be obtained from the takeover. Further, the opportunities for a potential acquirer to pressurize target shareholders into acceptance of an offer are likely to be considerably reduced if there is a rival exit offer on the table. Thus, whilst laws cannot mandate a competing offer, there are good reasons for those who design the rules about control transactions to do so in a way which facilitates competing offers.

There are a number of ways in which the rules on control transactions may facilitate competing bids. We have already noted[104] that the first model (shareholder decision-making) stops short of preventing the incumbent management from seeking a white knight, and in fact such action constitutes a common takeover 'defense' in systems based on that model. 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

[101] The partial offer must be for at least 60% of the target's shares and have been approved by the shareholders of the target: Art. 107 Legislative Decree 58.

[102] Art. 22(2) and 32(1) Loi sur les bourses. These provisions must be contained in the company's constitution. In the case of total disapplication this rule cannot be introduced after the company has become listed. In Portugal, Art. 187(4) Securities Code also permits the constitutions of unlisted companies to raise the mandatory bid threshold to 50%.

[103] See recently Marc Goergen and Luc Renneboog, *Shareholder Wealth Effects in Large European Takeover Bids* (Working Paper 2002, available at ssrn.com). They point out that, for longer event windows, differences between the types of bids are no longer statistically significant.

[104] *Supra* 7.2.2.

the first offer, unless it has been declared uncouditional, either for any reason or if a competing offer emerges.[105]

More generally, as Romano has remarked,[106] '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.' Thns, rules, osteusibly aimed at other problems, may have a significant impact on the chances that an alternative offer will be forthcoming. Examples are 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); or rules requiring disclosure to the market of the beneficial ownership of shareholdings above a certain size[107] (which are designed to facilitate the smooth operation of the market, but may give a potential competitor advance warning that an offer for a particular target company is likely to be forthcoming).

The cost associated with rules which facilitate competing bids is that they may reduce the incentives for first offers to be made. There is empirical evidence that 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 and, thus, the disciplinary effect on target management of the threat of a takeover may be diluted.[108]

There are a number of techniques which can be used to mitigate the costs of rules which facilitate competing bids. 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 uot be forthcoming without some protection against the emergence of a competitor, the directors of the target could be permitted to coutract not to seek a white knight.[109] More effective from the first offeror's point of view would be a financial commitment from the target company in the form of a '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., bur treated with reserve by the City Code because of their potential impact upon

[105] This is the predominant rule in takeover regulations, even in the U.S. (see §14(d)5 1934 Securities Exchange Act and Rule 14d-7). However, the City Code (UK) does not accept the principle of release of acceptances of the offer when a competing bid emerges, so that professional investors do not accept offers until the very end of the offer period. Note, however, Rule 34 which enables acceptors to withdraw if the offeror has not declared its offer unconditional within 21 days of the first closing date.

[106] *Supra* note 2, 28. [107] See *supra* note 35.

[108] 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). The debate is examined by Romano, *supra* note 2, 27–38.

[109] This is the situation in the UK: see *Dawson International plc v. Coats Patons plc* [1990] BUTTERWORTHS COMPANY LAW CASES 560. Self-interested nse of this power is then policed by subjecting its exercise to review by reference to the board's fidnciary duties. Even so, if, despite the contractual undertaking, a competing bidder does emerge, the target board may not contract out of its fiduciary duty to advise its shareholders about which bid is in their interests.

the principle of shareholder decision-making.[110] 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 inro the competiror's winning offer if its owu 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,[111] rules requiring the public disclosure of share stakes limit the opportunity to make cheap pre-bid purchases of the target's shares.[112]

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. Actual regulation seems more concerned with controlling the opportunities which competing bids afford the board of the target to push the bid which they favor, rather than with the impact of the competing bid on the first bidder. Thus, takeover regulation normally seeks to ensure that competing bidders are treated equally in their access to information about the target.[113]

7.3.5 Acquisition of dissenting minorities

The atomized quality of shareholder decision-making under a general offer can operate so as to confer hold-up powers on minority shareholders who do not accept the offer, despite the fact that the majority of the shareholders have chosen to do so. Minority shareholders may decide not to accept the offer in the hope of negotiating more favorable terms with the acquirer after the bid has closed. This strategy will be available to the minority where they are sure that the majority will accept the offer and that the acquirer wishes to achieve 100% ownership of the target.

In a number of jurisdictions, the issue of minority hold-ups is directly addressed by takeover provisions which give the acquirer compulsory purchase powers over the dissentient minority's shares. The compulsory buy-out threshold is usually set at the 90% or 95% level[114] and issue of price is settled by requiring the minority to be given the same consideration as was offered in the bid. Other countries (such as the U.S. and Japan) have more general provisions permitting a

[110] Rnle 21.2 City Code sets an upper limit on inducement fees of 1% of the offer valne. It also requires the arrangement to be disclosed in the offer document and the offeree board and its financial adviser to confirm to the Panel that they believe the inducement fee is in the best interests of the target shareholders.

[111] See, e.g., Preamble Insider Dealing Directive [1989] OJ L 334/30. Details are controversial, *cf.* Klaus J. Hopt, *Takeovers, Secrecy and Conflicts of Interests*, in Payne, *supra* note 83, 33, 38–50.

[112] See *supra* note 35. And if the acceptors of the first bid are free to withdraw their acceptance, the first bidder will not be able to recoup costs by assenting the shares represented by the acceptances into the rival's bid.

[113] See, e.g., Rule 20.2 City Code.

[114] See also *supra* 6.2.2.2. Though it is important to see whether this is a percentage of the shares offered for or a percentage of the issued shares of the class. In the former case, shares held by the offeror before the bid do not count.

large majority shareholder to acquire compulsorily the shares of a minority, no matter whether the majority was acquired in a bid or not. In this case fixing a fair price may be more controversial.

In some countries the right of the offeror at the 90%-plus level to acquire minority shares compulsorily is 'balanced' by the right of minorities to be bought out at that level, a right which, again, may be tied to a preceding takeover offer or not.[115] However, functionally, the two are very different. Within control transactions, the effect of a right to be bought out is to reduce 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, because the latter rule is not linked to any particular level of acceptances.[116]

7.4 Agency Issues Where There are Controlling Shareholders

In the two models developed in Section 7.2 in relation to companies with dispersed shareholdings, we saw that the iuitial question was the allocation of the decision rights on the offer to the shareholders alone or to the target board and the shareholders jointly. Where there is a controlling shareholder or shareholding group this decision loses much of its significance, for, on either basis, the controlling shareholder will determine whether the bid is accepted. However, the shareholder/board agency issues are here replaced by minority/majority agency problems, which in tnrn may exacerbate agency issues as between the acquirer and the non-controlling shareholders.

As with shareholder/board issues, 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. This is particularly so where the object of the regulation is the conduct of the selling (and thus existing) majority shareholder. Where, however, the aim is to provide an exit opportunity for all shareholders on fair terms, this goes beyond traditional company law in most jurisdictions and requires specialized rules.

In either case, the central question is, again, whether the law imposes a sharing rule when there is a sale of control.[117] This may be done either by imposing a duty on the selling majority shareholder to share the control premium with the non-selling minority (sharing of the consideration), or, going further, by imposing a duty upon the purchaser of the controlling block to offer to buy

[115] Both types of rule are discussed in greater detail in Forum Europaeum Corporate Group Law, *Corporate Group Law for Europe*, 1 European Business Organisation Law Review 165, 226 *et seq.* (2000). The 2003 Takeover Bids Directive requires both a squeeze out and a sell ont right. See also *supra* 6.2.2.1 (discussing appraisal rights).

[116] See text attached to *supra* uote 82. Takeover regulation usually requires no more thau that the offeror bring its holdings to 50% of the voting shares before the offer is declared unconditional.

[117] See *supra* 7.3.2 and 7.3.3.

the non-controlling shares at the same price as that obtaiued by the controlling shareholder (sharing of both the consideration and the exit opportunity).

In the U.S., where, as in the corporate laws of other jurisdictions, the sale of controlling shares at a premium price is not *per se* unlawful, the courts, have imposed standards upon the conduct of controlling shareholders by way of fiduciary duties owed by such shareholders to other shareholders.[118] These duties have been extended to the point of imposing an obligation upon the controlling seller either to compensate the remaining shareholders for foreseeable harm caused by the sale[119] or to share the premium with the non-controlling shareholders when the sale can be identified as involving the alienation of something belouging to all shareholders.[120] Despite academic argument to the contrary,[121] U.S. courts have not adopted a general equal opportunity principle which might have led them to generate a right for non-controlling shareholders to exit on no less favorable terms to those received by the controller. However, it is worth noting that, since the U.S. rnles are a development of general corporate law fiduciary duties, they are apt to catch sales of control in closely held companies as well as in publicly traded oues.

As far as duties on the acquirer are concerned, many of the rules designed to deal with acquirer opportunism vis-à-vis dispersed shareholders will also protect minority shareholders. Thus, an acquirer who wishes to obtain complete control of a target will not be able to offer a higher price to a majority shareholder if the rules require the public offer to reflect the price paid outside the bid. The greatest controversy, however, revolves around the question of whether the mandatory bid rule should be applied where offers involve as well a transfer of control and not just purchases from non-controlling shareholders.[122]

It can be argued that there is a vital difference where the sale is by an existing controlling shareholder, because the minority is no worse off after the control shift than they were 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 differeut and less successful strategy; may be less respectful of the minority's interests and rights; or may just simply use the acquired control systematically for implementing a group strategy at the expense of the new group member company and its minority shareholders.[123]

[118] See also *supra* 5.2.3 (discussing controlling shareholders' fiduciary duties in the context of related party transactions).

[119] As in the looting cases: see *Gerdes* v. *Reynolds* 28 New York Supplement Reporter 2d Series 622 (1941).

[120] *Perlman* v. *Feldman* 219 Federal Reporter 2d Series 173 (1955); *Brown* v. *Halbert* 76 California Reporter 781 (1969).

[121] 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 478–498 (1986).

[122] See *supra* 7.3.

[123] In the lasr case, it may be beneficial for the shareholders of the holding company to allocate business opportunities to another group member, but in that situation the minority shareholders in the uew subsidiary will lose ont. See also *supra* 7.1.2.2 (majority/minority agency issues) and 4.1.2 (creditors' perspective).

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 reliauce 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.[124]

The costs of the mandatory exit right are potentially much greater in a situation of transfer of control from a controlling shareholder than where control is transferred from the management of the target. In the latter case, transferors of the shares which become the controlling hlock have nothing more to sell the acquirer than any other shareholder (but for being first in line). In the case of a transfer from controlling shareholders, on the other hand, a mandatory exit rule requires the transferor to give up the private benefits of control for a price which does not reflect those advantages. Thus, the disincentive effect of a mandatory sharing of bid premiums might be thought to be significant.[125] Fewer control shifts will occur because, not only must the acqnirer bid for the whole share capital, but also it is unable to offer the transferor any premium for control. In countries with concentrated shareholdings, especially in family hands, this may be seen as a strong objection to the mandatory bid rule.[126]

However, although this may be a strong objection to a rule reqniring pro-rata sharing of the premium, it is not necessarily a strong objection to the mandatory bid requirement, if the price may be fixed at a lower level than the price paid for the controlling shares. As we have seen, some systems do allow variations between the price offered to the minority and that paid for the controlling shares.[127] However, other systems are committed to the principle of equality of treatment even in the case of sales of controlling blocks.

France is particularly interesting here hecause it developed an exit mechanism for minorities in relation to transfers of control before it did so for acquisitions of control.[128] From the early 1970s the French regulators imposed an obligation on those who acquired controlling blocks from existing controllers to stand in the market and buy such shares of the non-controlling shareholders as were offered to them. Only in 1989 was the mandatory offer introduced, applying to acquisitions as well as transfers of control, and only in the 1990s did it become an obligation to offer to acquire all the outstanding shares, being previously limited to two-thirds. The obligation to stand in the market survives in the form of the

[124] For a general discussion of this issue, see Jnrgen Reul, DIE PFLICHT ZUR GLEICHBEHANDLUNG DER AKTIONÄRE BEI PRIVATEN KONTROLLTRANSAKTIONEN 277 *et seq.* (1991).

[125] John C. Coffee, *Regulating the Market for Corporate Control*, 84 COLUMBIA LAW REVIEW 1145, 1282–1289 (1984).

[126] See Alexander Dyck and Luigi Zingales, *Private Benefits of Control: An International Comparison* (Working Paper 2002, available at cepr.org) (sample of 412 control transactions in 39 countries: control premia vary between -4% and 65%); Rolf Skog, DOES SWEDEN NEED A MANDATORY BID RULE? A CRITICAL ANALYSIS (1995), though Sweden in the end did adopt the mandatory bid rule in 1999. As to the reasous for the adoption in 1999, see Klaus J. Hopt, *Common Principles of Corporate Governance*, in Joseph McCahery, Piet Moerland, Theo Raaijmakers and Luc Renneboog (eds.), CORPORATE GOVERNANCE REGIMES, CONVERGENCE AND DIVERSITY 175, 180 (2002).

[127] See *supra* 7.3.3. [128] Viandier, *supra* note 59, 369–72.

garantie de cours.[129] The iuteresting aspect of the *garantie de cours* from the point of view of the current discussion is that the provisions governing it insist that the price offered be that paid for the block which conferred control.[130] This history suggest that the Freuch rule-maker regarded minority protection in transfers of control as initially more important than such protection in simple acquisitions of control.[131] A firm guarantee of the highest price on a control shift no doubt encourages investment in majority-coutrolled companies, even if it may discourage bids for such companies.

7.5 AGENCY PROBLEMS OF NON-SHAREHOLDER GROUPS

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.[132] The responses of takeover regulation to this issue can be put, broadly, into one of three classes. First, those systems which locate with 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.[133] Thus, Rule 24.1 City Code requires the offeror to state its intentions with regard to, *inter alia*, the continued employment of the employees of the target, but this disclosure obligation sits in a sense in a vacuum (employees are given no decision rights in relation to the bid).[134]

Where, however, the board is given a significant role in the takeover process, a second pattern can be discerned, which is to regard the snrvival of target

[129] Chapter IV Règlement Général CMF. See also Hubert de Vanplane and Jean-Pierre Bornet, DROIT DES MARCHÉS FINANCIERS N°806–9 (3rd ed. 2001).The *garantie de cours* sits nneasily with the now fully-fledged mandatory bid obligation, and the supervisory authority (*supra* note 8) can insist on the mandatory bid procedure if this is necessary to ensnre equality: Art. 5-4-3 Règlement Général CMF. It has some advantages over the mandatory bid, for example, speed, becanse the transferee need stand in the market for only 10 working days and the procedure is simpler.

[130] Art. 5-4-2 Règlement Général CMF.

[131] Equally, the Commission's High Level Group, *supra* note 27, has proposed no exception to its presumption in favor of the highest price in cases where there is a transfer of control. See text attached to *supra* note 95.

[132] Margaret M. Blair, OWNERSHIP AND CONTROL (1995); Andrei Shleifer and Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in Alan J. Auerbach (ed.), CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33 (1988).

[133] Of course, non-shareholder interests may be protected through mechanisms existing outside company law entirely. For example, separate structures for the review of offers on competition grounds are very widespread.

[134] The extent to which the employees should be informed or be influential in the takeover process was also one of the contentious issues in the deadlock over the EU Proposal for a Takeover Directive. The Parliament's attempt to ride all possihle horses can be seen in one of its proposed amendmeuts to the effect that 'the board of the offeree is to act in the interests of the company as a whole, in particular in the interests of corporate policy and its constitution, shareholders and staff, and with a view to safegnarding jobs, and must not deny the holders of securities the opportunity to decide on the merits of the bid.' Compare Art. 3 and Art. 13, Takeover Bids Directive.

management as a proxy for the furtherance of the interests of non-shareholder groups. Thus, in the U.S., one popular form of state anti-takeover statute ('constituency statutes') consists of expanding widely the range of interests beyond the shareholders' interests which management is entitled (but not bound) to take into account when responding to a takeover bid.[135] 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 such rules only to the extent that their interests happen to coincide with those of the target board.[136]

The third pattern involves taking the step of giving the non-shareholders a decision-making role, though it is a pattern to be found in practice only in relation to employee interests. In those jurisdictions (notably Germany and the Netherlands) in which company law is used in a significant way to regulate the process of contracting for labor,[137] 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 decisions (perhaps to the point where control shifts which are unacceptable to the employee representatives are hard to achieve). Moreover, in this situation the disclosure provisions of the specific takeover rules and general corporate law provisions defining the company so as to include non-shareholder interests operate in an entirely different institutional context and may have real bite.[138]

The Dutch system uniquely goes beyond the general board representation provisions and comes close to giving the employees principal status in relation to control shifts. In a company with more than 100 employees, the board of the target must consult the works council. Although the board may in principle proceed with the transfer against the advice of the works council, if the council opposes the transfer, it is delayed for a month during which the council may file an appeal with the court.[139] The test to be applied by the court is whether the company, weighing all the interests involved, could reasonably have arrived at its

[135] See, e.g., §717(b) New York Business Corporation Law.

[136] See also Mark J. Roe, Political Determinants of Corporate Governance 45 (2002) (labor's influence is indirect and weak, constituency laws are made by and for managers).

[137] See *supra* 3.3.

[138] For information provisions in Germany see §11(2) Ubernahmegesetz and §2 Ubernahmegesetz-Angebotsverordnung (Germany). For the inclusive definition of the interests to be considered in Germany, see Michael Kort, N°52–78 §76, in Klaus J. Hopt and Herbert Wiedemann (eds.), Grosskommentar zum Aktiengesetz (4th ed. 2003) and briefly Uwe Huffer, Aktiengesetz N°12–15 §76 (5th ed. 2002).

[139] Jan R. Schaafsma, *Hostile Takeover Bids and Defenses: The Netherlands*, in Hopt and Wymeersch, *supra* note 2, 217.

decision. Although this is formally an 'outside trustee' strategy (the judge as decision-maker), it may be that the delays involved in the consultation and appeal processes turn the works council in practice into a veto-holder.

7.6 Explaining Differences in the Regulation of Control Transactions

We have analyzed takeover regulation along two main and one minor dimension. The major dimensions were the location of decision-making on the bid and the protection of target shareholders (especially non-controlling shareholders) against opportunism on the part of the acquirer or transferor. 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 we have studied puts the goal of maximizing the number of takeovers at the centre 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). None of our jurisdictions conforms to this pattern: the regulation of agency issues is a better, if more complex, explanation of the goals and effects of national regulatory systems.

The second is that there are important trade-offs involved in the placing of a particular system along the three (two major, one minor) dimensions. Thus, provisions, though aimed at protecting target shareholders, may operate indirectly so as to protect target management.[140] 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 (France, UK) also have the most developed rules against acquirer opportunism. Deprived of the protection of centralized management, the target shareholders need explicit regulatory intervention as against acquirers.

Is it possible, however, to go beyond an analysis of the effects of different types of regulation on the chances of acquirer success, and to explain why regulation takes the form it does in different countries? Any attempt to take this further step requires placing the legal rules in a broader economic and social context. One explanatory factor is the importance of public capital markets in the jurisdictions in question and, associated with that, the growth of institutional shareholding. In the case of the UK, the argument might be presented as follows. Capital

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

markets are and for a long time have been of cenrral importance in the economy; family shareholding blocks, by contrast, have not been of great importance since the Second World War; and, over the past 30 years, institutional shareholding has grown to the point where it represents over two thirds of the shares quoted on the London Stock Exchange. In consequence, a regulatory structure which reflects the interests of institutional shareholders, protecting them against both managerial entrenchment and acquirer opportunism is perhaps a natural growth.[141] The absence of family-held blocks also reduces the costs associated of some of the protective devices, notably the mandatory bid.

Equally, the recent development of the regulatory structure in France, especially the growing acceptance of restrictious on post-bid defenses and the extension of the mandatory bid and orher devices to protect against acquirer opportunism, can be linked to the modern development of the French capital markets and a lessening of state influence over the policy of major French companies. Finally, the modernization of securities laws in many European countries over the past decade and, as part of that exercise, the adoption of no-frustration and shareholder equality rules can be linked with the growth of capital markets, as the private investor has replaced the taxpayer as the funder of many activities previously carried on within or through the state.[142]

Yet, by itself, reference to the growing importance of capital markets is not convincing. It does not explain the UK/U.S. (and now increasingly Europe/U.S.) divide on the location of decision-making over control transactions. An explanation which had regard only to the importance of capital markets within an ecouomy would surely lead one to expect that the U.S. rules would favor shareholders only as decision makers and, in consequence, provide a favorable climate for hostile bids. However, as we have noted, the U.S. in the 1990s generated only 333 hostile bids whilst the UK economy, six times smaller, generated 135 such bids.[143] Although there are a number of possible explanations for these figures, they do suggest that regulation of control transactions in the U.S., despite the importance of capital markets in that country, is less favorable to hostile bids than in the UK.

What might the additional or alternative factors be? One might be the relative political influence in the UK and the U.S. of the groups who think of themselves as advantaged or disadvantaged by a rule of sole shareholder decision-making. Thus, in the UK, the political influence of financial interests in the City was sufficiently powerful to secure the delegation from the legislature to City institutions of the power to formulate the rules to govern control transactions. The British procedure for producing a set of takeover rules (via the City Panel) gave

[141] See Paul Davies, *Institutional Investors in the United Kingdom*, in Theodor Baums, Richard M. Buxbaum and Klans J. Hopt (eds.), INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 257 (1994); same, *Shareholder Value: Company Law and Securities Markets Law—A British View*, in Klaus J. Hopt and Eddy Wymeersch (eds.), CAPITAL MARKETS AND COMPANY LAW 261 (2003).

[142] See the laws listed *supra* note 8.

[143] See Kirchner and Painter, *supra* note 75; see also Goergen and Renneboog, *supra* note 103.

institutional shareholders in the UK an advantage over the representatives of management. UK regulation 'is not imposed from the outside by a detached governmental body but rather by a group that has strong connections to the interested parties' and that group 'gave less weight to managerial interests because of the close connection at least some of them had with the interests of shareholders.'[144] By contrast, the constitueucy statutes of the U.S. are the product of state legislatures, which are not so much 'detached governmental bodies' but vehicles for the expression of particularisr local interests of the type likely to suffer in hostile bids. They are thus relatively fertile ground for lobbyists in the managerial cause.[145] Finally, the courts could be expected in the fashioning of common law standards to be sensitive to the balance of political power.

A mixture of structural changes and political developments can also be used to explain the interesring position of Germany. Ou the one hand, changes in corporate finance have redneed the predominance of universal banks and increased the importance of capital markets in Germany, whilst tax changes may lead to the unwinding of controlling blocks in companies, so that the beginnings of a market for corporate control can be seen there.[146] On the other hand, and partly in response to these structural changes, the German Government iu the end led the opposition to the Commission's Proposal for a Takeover Directive which reflected the model of exclusive shareholder decision-making.[147] Here, a social-democratic governmeut put the interests of old industry and the trade unions ahead of those of the Frankfurt Stock Exchange, German financial interests generally, and the majority of academics.

Elsewhere in continental Europe, although the success of the new wave in takeover regulation seems to represent a victory for the non-frustration model, it could be said that, perhaps outside France, the new rules have not yet been fully tested. At the moment, concentrated shareholdings, the availability of pre-bid defensive tactics, and the existence of structural barriers to takeovers operate to shield continental jurisdictions from much of the practical effect of hostile takeovers;[148] the regnlatory framework of control transactions might come under much greater pressure were these defenses to be substantially watered down.

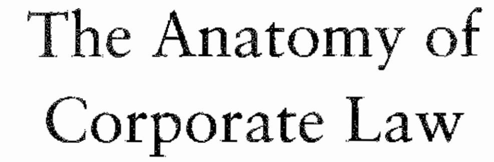
[144] Bebchuk and Ferrell, *supra* note 52, 1192–3.

[145] See Gilson, *supra* note 24, 49–50; Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast between the United States and England*, COLUMBIA BUSINESS LAW REVIEW 51, 70–75 (1998).

[146] See Hopt, *supra* note 126, 175, 186–8.

[147] See *supra* notes 27 and 32.

[148] See Goergen and Renneboog, *supra* note 103 (hostile takeovers are largely ruled out in continental Europe).



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