European takeover regulation

SUMMARY

To foster corporate restructuring and capital market integration, the European Commission has repeatedly attempted to introduce Europe-wide takeover regulation, but has encountered strong resistance. We trace the sources of this resistance to differences in corporate governance arrangements across member states and outline the economic effects of takeover regulation, focusing in particular on possible provisions of particular relevance to the European debate. Regulation may stipulate that the same price be offered to all shareholders (a 'mandatory bid' rule) and/or that differentiation of voting-rights be voided when a bidder acquires a large enough portion of a firm's shares (a 'break-through' rule). The impact of these and other rules depends on the existing structure of corporate ownership and control, which is very heterogeneous in Europe. And while a break-through rule promotes takeovers, a mandatory bid rule tends to prevent them. Hence, the two rules would tend to offset each other if introduced together, and introducing a strict mandatory bid rule alone would slow down corporate restructuring. We argue that hostile takeovers are a rather blunt instrument for achieving desirable contestability of control, and their regulation is only one of many corporate governance mechanisms to be honed in order to promote corporate restructuring in Europe.

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1. INTRODUCTION

After decades of failed attempts and a stinging European Parliament defeat in 2001, the European Commission remains committed to the idea of a pan-European takeover directive. The Commission argues that more takeovers will lead to more restructuring, and Europe badly needs more restructuring if it wants to catch up with, and overtake, the United States as set out in the Lisbon declaration. In 2002 a High Level Group of Company Law Experts appointed by the European Commission and under the leadership of the Dutch Law Professor Jaap Winter presented two reports; a first report on European takeover regulation and a final report on a modern regulatory framework for company law in the EU. In the analysis of the Winter Group the core problem is the entrenched ownership and control structures in most member states and the asymmetry of rules regulating takeovers.

To achieve more contestability of control and a level playing field in takeover markets, the Group proposed a set of measures, most of them included in the failed

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2001 draft directive, intended to limit the controlling shareholders' ability to resist takeover bids. In particular, the proposal required shareholders rather than management to approve any *defensive measures* (changes in the firm's assets or liabilities, meant to make takeovers unprofitable, to be implemented when control is threatened by an outside bid). It also advocated a strict *mandatory bid rule* (requiring the bidder to pay all shareholders the same price). But the Group went further in proposing that differentiation of shares' voting rights, one of the most common methods for separating ownership and control, should be voided in votes on defensive measures once a takeover bid has been announced. Moreover, a bidder who had achieved a qualified majority of equity could undo any statutory defences, including any differentiation of votes (the so-called *break-through rule*). The break-through rule was later dropped from the draft directive after intense criticism from several member states and controlling owners affected by the rule.

In this paper, we discuss the potential economic implications of mandatory bid and break-through rules, aiming to illustrate some fundamental issues in takeover regulation and their relevance in the European context. Despite their far-reaching nature and broad impact, in fact, the proposals from the Winter Group and the Commission are rather far removed from economic analysis. Building on the extensive relevant economic literature, both empirical and theoretical, we provide here a conceptual framework for analysing the interrelationship between the market for corporate control and corporate governance. The framework also makes it possible to understand how the effects of specific pieces of regulation depend on the context, in particular on existing structures of ownership and control, and to address the issue of whether and which takeover regulation and corporate governance reforms would Europe need in order to foster restructuring.

We proceed as follows. Section 2 discusses takeover activity within Europe and how its intensity may be influenced by several types of 'barriers' and, in particular, by the prevalence of controlling blocks. Section 3 discusses the principles of takeover regulation, and Section 4 describes national takeover regulation and attempts to regulate takeovers at the EU level. Section 5 outlines the close relationship between takeover regulation and wider corporate governance issues, and Section 6 provides an economic analysis of defensive measures, the mandatory bid rule, and the break-through rule.

In the remainder of this section we outline the main theoretical and policy arguments of the paper, to which we return in the concluding Section 7 with some policy recommendations.

1.1. Takeovers and corporate governance

Takeover regulation influences the distribution of gains from takeovers not only between the bidding firm and the target firm, but also between controlling and minority shareholders in the target firm. Hence, it has implications not only for control bids *ex post*, but also for the *ex ante* structure of control. If more surplus is

allocated to the bidding firm, the incentives to make a bid are stronger. And if more surplus can be appropriated by minority shareholders, it is less attractive to hold controlling blocks in firms that may be takeover targets.

Takeover regulations, such as the Commission's draft directive or the UK City Code, include numerous provisions. Many are generally deemed sensible, but regulations regarding specific defensive measures, mandatory bid rules, and break-through rules are still controversial, and we focus on them in this paper. We show that the effects of individual pieces of takeover regulation often depend critically on the ownership and control structure in the target firm. For example, neither the mandatory bid rule nor the break-through rule have any impact when a firm's shares are widely dispersed. More importantly, the specific break-through rule proposed by the Winter Group only affects dual class shares and not other control instruments. We also show that when there is a controlling minority shareholder the mandatory bid rule makes it more costly to take over a firm, and the break-through rule makes it cheaper. So, the two rules have opposite effects on takeover activity incentives.

The Commission's draft directive envisions only a strict mandatory bid rule, and no break-through rule. This would further entrench existing control structures and reduce contestability, contrary to the intention of fostering efficiency. As we shall see below a strict mandatory bid rule does eliminate some value reducing takeover bids, but at the cost of also getting rid of some value-increasing bids. In particular, the mandatory bid rule effectively shuts down the trade in controlling blocks, the dominant form for control transfer in most of Europe. While the mandatory bid rule in the draft directive is unambiguously detrimental to promoting restructuring, it may or may not be good for minority protection: the rule increases the compensation to minority shareholders in case of a successful takeover, but it decreases the likelihood of a takeover. Which effect dominates is ultimately an empirical issue.

Introducing a break-through rule would undermine the mandatory bid rule, and allow additional (value-reducing and value-increasing) bids to succeed. The break-through rule alone would unambiguously promote takeover activity and contestability, essentially by lowering the cost of a successful bid. However, since the rule fundamentally alters the initial contracts of the controlling owners, it represents a massive *ex post* government intervention. The resulting uncertainty as to property rights regime potentially entails large *ex ante* costs, as it reduces incentives for entrepreneurship and for controlling owners to exercise corporate governance.

These costs have to be weighed against potential benefits. Contestability of control is a worthwhile goal for European takeover regulation, but its meaning and implications must be understood in the context of existing ownership and control arrangements in Europe. The threat of takeovers disciplines controlling owners and managers, and actual takeovers can let more efficient owners and managers achieve control. Such contestability, however, is neither sufficient nor necessary for good corporate governance at the level of the individual firm. There are many examples of successful family firms where control is not and has never been contestable. In the

system as a whole, the benefits of contestability must be weighed against any negative effects it might have on incentives for entrepreneurial activity and monitoring by large controlling shareholders, and on the protection of minority investors.

1.2. Policy issues

Regulation that encourages hostile takeovers in order to increase contestability need not guarantee that the existing corporate resources are managed more efficiently: takeovers can mitigate agency problems between managers and shareholders, but are themselves subject to agency problems, and are just one of many mechanisms addressing such problems in the broader corporate governance framework. Each of the relevant mechanisms has costs and benefits and, since the various corporate governance mechanisms are complementary and highly interconnected, changes in one component almost always entail some costs. The challenge in corporate governance is to balance the different mechanisms' costs and benefits in that broader context.

Our analysis below also indicates that while creating a level playing field in the market for corporate control is a noble objective, it need not be achieved by harmonization of takeover regulation, because common rules have very different effects in different environments. In particular, the effects of the mandatory bid rule and a break-through rule of the type proposed by the Winter Group depend on the ownership and control structure in the target firm. Given the considerable variation in ownership and control within the European Union, most notably between the UK and the rest of Europe, the mandatory bid rule, for instance, prevents the takeover of a typical German firm with its controlling owners, but not that of a typical UK firm with its dispersed ownership.

2. OWNERSHIP AND CONTROL IN CORPORATE EUROPE

Is the Commission's preoccupation with promotion of industry restructuring justified? Even though there are large fluctuations over time in individual countries, the United States has been more successful than Europe in restructuring its industry, at least during the 1970s and the 1980s (Holmström and Kaplan, 2001). A considerable share of this restructuring was achieved through hostile takeovers, and a potential hostile bid played an important role even when transactions were negotiated. Within Europe, hostile takeovers were primarily confined to the United Kingdom. Hostile takeovers in the sense of tender offers launched in the market have been very rare in Continental Europe, at least until recently. For instance, in 1989 there were only four hostile takeovers in all the rest of the EU15, compared to 36 in the UK (Becht *et al.*, 2002). The turnover of control was also much higher in the UK with the number of friendly transactions alone clearly outnumbering those on the European Continent.

The European situation changed somewhat during the 1990s, with a large increase in the total number of control transactions. The number of hostile takeovers

remained negligible until the last few years of the 1990s, however. In 1999 the same number of hostile takeovers took place in the UK as in the (much larger) rest of the EU15 (Becht *et al.*, 2002). However, there was some variation among the rest of the countries. In Sweden, a total of about 250 takeovers occurred during the 1990–2001 period, which corresponds to 9% of the number of listed firms (Berglöf *et al.*, 2003). In Germany, a much larger economy with many more listed firms than Sweden, only about 100 takeovers occurred during the same period.

In the US, overall restructuring activity remained about the same, but the component reflecting hostile takeovers dropped during the 1990s, with a brief resurgence in the middle of the decade. This decline in hostile control transactions can be largely attributed to increasingly management-friendly judges in key US states, such as Delaware, where most large companies are incorporated (Holmström and Kaplan, 2001). A series of court decisions came out in favour of managerial defences and of a broad interpretation of the business judgment rule giving management discretion over key strategic decisions.

In interpreting this evidence, it is important to remember that hostile and friendly takeovers may be harder to differentiate than the names may suggest. The distinction is normally based on whether the board in the target firm supported the bid. But the vote of the board could be influenced by many things, including the prospects of the bid eventually succeeding. In fact, many seemingly friendly transactions have hostile components. Jenkinson and Ljungqvist (2001) document a considerable degree of hostility in a number of control transactions in Germany that fall outside of the official classification of hostile takeovers.

Control blocks are also traded without formal takeovers taking place. Köke (2000) examines a larger sample of almost 1000 German firms (large listed, medium-sized and/or non-listed firms) over the years 1987 to 1994. He finds that there is significant trading in large share blocks, and that the vast majority of these transactions involve controlling blocks. On average, 7% of control changes per year in Germany compared to 6.3% in Belgium, to 6.7% in the US, and to 9% in the UK. Such changes in control are typically followed by increased management and board turnover, more asset restructuring and layoffs.

In addition, there is an active 'private' market for corporate assets and corporate control outside the public exchanges (Wymeersch, 1998). In terms of number of transactions, about half the number of transactions taking place worldwide involve European companies. These transactions mostly involve privately owned firms, including subsidiaries and divisions of listed corporations. Both in terms of numbers of transactions and of turnover, this market exceeds the markets for public takeover bids.

2.1. Takeover barriers

A number of factors explain the different intensity of takeover activity in Continental Europe, where so-called 'takeover barriers' are common and play a role similar to

that of pre-bid and post-bid takeover defences, widely used in the US, in entrenching target management (Ferrarini, 2002).

Takeover barriers may be 'structural', part of the institutional setting. For example, the influence on corporate decisions by banks and employees may make takeovers more difficult: this is especially relevant to Germany, but also to other countries. Co-determination power of worker representatives and close bank-firm relationships make takeovers difficult to the extent that employees and banks side with incumbent management or controlling owners against hostile bidders, as may be in their interest if employees and creditors somehow lose out when the firm is taken over (see Pagano and Volpin, 2001, and Cespa and Cestone, 2002). Empirical evidence from the US, however, suggests that wage cuts explain only a small fraction of takeover gains, and there is little evidence that creditors suffer substantial losses in takeovers.[1] Of course, the size itself of equity markets can also act as a structural barrier, since only firms listed on exchanges can be subjected to hostile bids. If only a small fraction of a country's firms are listed, as is the case for example in Germany and Italy, then this constitutes a limit to contestability of control in that country's industry. An obvious way to foster contestability is to encourage public listings of firms. Takeover regulation indirectly affects the incentives to list through its impact on the distribution of gains from a future takeover bid. However, takeover rules that create uncertainty about fundamental property rights of the controlling owner discourage listings.

Other barriers are 'technical', specific to an individual firm's governance structure as laid down in the corporate charter. They hinder takeover activity by reallocating powers across management and workers, but especially across shareholders. Examples of such common technical barriers that are specifically aimed at frustrating hostile bids are restrictions on the transferability of shares and on voting rights. Dual-class shares, pyramidal groups and cross-shareholdings are also common ways to separate ownership from control, thereby also providing protection against unfriendly acquisition attempts. In what follows we focus our discussion on such ownership and control structures as a barrier to takeovers.

2.2. Ownership and control

Recent comparable data on ownership and control collected within the European Corporate Governance Network (summarized in Barca and Becht, 2001) make it possible to assess the extent to which separation of ownership from control by entrenched incumbents is a serious obstacle to hostile takeovers in Europe, and possibly to restructuring more generally.

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[1] For a survey of the evidence, see Burkart (1999). Close relationships with the bank is not always a guarantee against a hostile bid. Franks and Mayer (1998) show that in all three cases of post-war hostile takeovers in Germany the target company's house bank exerted considerable influence over the outcome through the chairmanship of the supervisory board. The same probably happened for many potential hostile bids that never materialized.

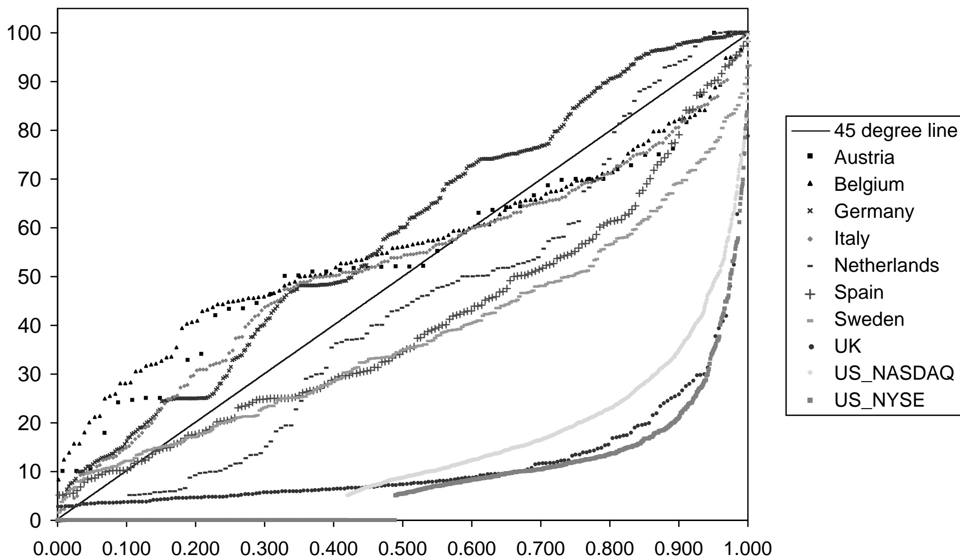

Figure 1. Percentile plot of largest ultimate voting blocks

Source: Barca and Becht (2001).

Corporate Europe spans a wide range of ownership and control structures, ranging from closely held family firms to firms with widely dispersed shareholdings. As in much of the rest of the world (the UK and the US with widely dispersed shareholding are notable exceptions) most companies have a large controlling shareholder (Barca and Becht, 2001; La Porta *et al.*, 1999). Interestingly, there is also considerable variation in ownership concentration within Continental Europe. In half of the listed non-financial firms in Austria, Belgium, Germany and Italy a single shareholder controls more than 50% of the votes (compared to 9.9% in the UK). In Dutch, Spanish and Swedish firms the median blockholder holds 43.5, 34.5, and 34.9%, respectively.

Figure 1 shows the distribution of firms by the size of the largest voting block in some selected countries. When each of the dotted lines are far below the diagonal line in the left-hand portion of the diagram, there are few firms with large controlling blocks. These distributions suggest a broad spectrum of ownership and control structures with large blockholders on the European Continent. In some cases the owner/manager controls a majority of the votes, and in others the largest blockholder has opted for a blocking minority stake. Also the observed clustering at certain levels of voting power illustrates the impact of laws and regulation. For instance, in Germany a 25% share constitutes a blocking minority, 50% is a simple majority, and 75% is a common qualified majority (able to prevent blocking opposition). Not surprisingly, the relevant dotted line features steps at those percentages, indicating that the largest

shareholder of unusually many firms is just able to exert the corresponding amount of blocking, majority, or qualified majority control.

The share of votes controlled by the largest shareholder, however, is only one of the features shaping the governance structure in a firm. Other relevant aspects include how the large shareholder secures control, how the remaining voting and return rights are held, and the relationship between the controlling shareholder and top management. Moreover, it is interesting to know the identity of the controlling owners.

Most countries allow at least one of the three principal mechanisms for separating control from ownership (of cash flow rights):

(1) shares with differentiated voting power;
(2) pyramiding where control is exercised through several layers of companies; and
(3) cross-holdings, such that a corporation indirectly controls its own shares.

Empirically, Bennedsen and Nielsen (2002) have calculated that one-fifth of firms listed on European exchanges make use of differentiated votes, with the practice being particularly widespread in Scandinavia. Faccio and Lang (2002) report that pyramids are used by 19% of listed European firms that have a controlling shareholder at the 20% level. Pyramids are most prevalent in Norway (33.9%) and least prevalent in Finland (7.46%). Crossholdings are also used in Germany but are marginal in other countries.

The effectiveness of these mechanisms in separating ownership and control differs. Pyramiding is particularly powerful, because it works multiplicatively. If a 50% majority is necessary for controlling a firm, one can control a firm by owning 50% of a corporation that owns 50% of the firm's shares, hence with a mere 25% of the total equity at stake. More generally, the multiplier between capital and votes in the pyramid is $1/(^1/_2)^n$ if n denotes the number of levels in the pyramid. These control enhancing mechanisms are sometimes used together. By combining shares with different voting power and pyramiding, a controlling owner can maintain control over the company at the bottom of the pyramid with even smaller shares of its cash flow rights.

A *controlling minority shareholder* characterizes an ownership and control structure where an owner/manager has floated the firm on the market, selling the majority of shares to other shareholders, but retains control. The voting and cash-flow (or 'return') rights not controlled by the largest shareholder can be held in several ways. Often, the shares are widely dispersed, but *several* large shareholders with substantial blocks of shares are also common (Barca and Becht, 2001). For a sample of 5232 European companies, Faccio and Lang (2002) find that 39% of firms have at least two shareholders owning 10% or more of votes, and 16% have three shareholders each owning at least 10% of the votes. In order to evaluate the role of additional large blockholdings we need to know more about the relationship between the largest blockholder and other blockholders. A controlling minority shareholder could have sold a large block to a friendly investor. Alternatively, an investor could have accumulated a substantial block of previously dispersed shares more or less against the desire of

the controlling owner/manager. Whether the other large blockholders are friendly or hostile plays an important role in shaping the nature and dynamics of corporate governance in the firm, as does the identity of the controlling owner. Recent empirical research has tried to penetrate complex, often multi-layered ownership and control arrangements in search of ultimate controlling owners (LaPorta *et al.*, 1999; and Faccio and Lang, 2002). Most publicly traded firms in Europe are either widely held or family controlled. There is, however, a marked difference in the relative importance of these two categories across Europe. In Continental Europe, as in most other countries of the world, family controlled firms are in the majority. By contrast, widely held firms clearly outnumber family controlled firms in the UK and Ireland.

To understand the implications of minority control, consider why holding a large controlling stake in a firm would ever be in the interest of the founder, or of his family. From a diversification and liquidity perspective, large blocks are not likely candidates for inclusion in an individual's or family's portfolio. But if those in charge of running the firm also own a large stake, they have better incentives to take appropriate decisions. This can work to the advantage of other shareholders too, who just supply financial funds. As we will illustrate below, however, ownership of large blocks – whether by managers or by outside blockholders – is not unequivocally efficient, but comes with costs and benefits.

3. TAKEOVER AND MINORITY SHAREHOLDERS

Takeover regulation – whether implicitly or explicitly – influences how the takeover gains are shared between the bidder and the target firm, and thereby affects their respective incentives to make and accept a bid. Since granting the bidder a larger fraction of the takeover gains necessarily implies that target shareholders receive less of the surplus, any takeover regulation has to confront the trade-off between promoting the mobility of corporate control and protecting small shareholders.

To illustrate this general point we briefly review the well-known free-rider problem identified by Grossman and Hart (1980), which is central to the understanding of both how the tender offer process functions and how regulation affects takeovers. Grossman and Hart show that managers who are inefficient and/or pursue self-serving actions need not be vulnerable to a takeover bid, even though – or, indeed, precisely because – ownership is widely dispersed. Each small shareholder sees that his own decision to sell shares at the bid price has a negligible impact on the tender offer outcome. Thus, tendering shares is only optimal if the bid price at least matches the post-takeover share value. Otherwise 'free-riding' is preferable: shareholders who do not tender their shares capture the whole value improvement that the bidder can generate. As all small shareholders behave in the same manner, the bidder makes zero profit on the shares acquired in the tender offer: success of a value-increasing bid is a public good for the target shareholders, but each individual shareholder has an

incentive not to tender in order to 'free-ride'. As a result, there are too few takeover attempts, and if a takeover occurs, most of the gains go to target shareholders.[2]

3.1. Takeover regulation and minority shareholders

The literature has suggested ways in which takeover legislation may mitigate the free-rider problem. Grossman and Hart (1980) propose allowing bidders to exclude minority shareholders from part of the takeover gains, that is, dilute minority shareholder rights. If the post-takeover share value to the bidder is larger than that to the minority shareholders, in fact, the latter are willing to tender at a price that lets bidders makes a profit. Note also that the bid price does not depend upon whether or not unrestricted bids are mandatory: regardless of whether the mandatory bid rule is imposed, for a bid to succeed the offer need only exceed marginally the post-takeover minority share value.[3] The free-rider problem may also be solved by granting a successful bidder a *squeeze-out right*, that is, the right to compel remaining minority shareholders to sell their shares (Yarrow, 1985). The squeeze-out right affects the tendering decision in a similar manner as the dilution of minority shareholder rights. When a bid conditional upon acceptance of a large enough share (the *freeze-out* fraction) of the firm's equity is successful, all shareholders are forced to sell their shares on the terms of the original offer, and therefore may as well accept the original offer.

Thus, takeover regulation can affect the distribution of takeover gains, and thereby the bidder's incentives to undertake a bid, as well as the target shareholders' incentive to accept it. Now, both the Winter Report and the various unsuccessful draft takeover directives (like other takeover regulations such as the UK City Code and the federal US regulation) aim to protect minority shareholder interests as well as ensuring a well-functioning market for corporate control, where takeovers may create wealth by exploiting synergies and by disciplining management. In light of the above argument, however, the two objectives clearly conflict with each other. Strong (minority) shareholder protection discourages bidders because their profits are eroded by the target shareholders' 'free-rider' behaviour. To foster efficiency, a takeover mechanism must grant to bidders benefits that do not accrue to other shareholders on a pro-rata basis, and such private benefits conflict with equal treatment and protection of minority shareholders.

Consequently, a functioning market for corporate control cannot be pursued separately from the protection of minority shareholders. One goal has to be traded-off

[2] This implication of the 'free-rider' result is confirmed by numerous empirical studies (Burkart, 1999); other complementary reasons why a bidder may fail to make a profit are competition by other bidders and defensive actions by the incumbent management.

[3] The argument implicitly assumes that the takeover is value increasing, and the post-takeover minority share value that exceeds the current share value under the incumbent management. In a more general single bidder setting where the takeover may or may not be value increasing, the mandatory bid rule can prevent that minority shareholders incur a loss relative to the current share value. However, the mandatory bid rule never simultaneously secures a bid premium and provides effective protection: either the status quo (current share value) determines the bid price, in which case the takeover premium is zero, or the post-takeover minority share value determines the bid price in which case the mandatory bid rule has no impact (Burkart, 1999).

against the other. To the extent that shareholder protection increases the target shareholders' share of the takeover gains, it diminishes the bidder's private benefits, thereby resulting in a less active market for corporate control. This trade-off also implies that maximum minority protection is not in the target shareholders' best interest. Less shareholder protection improves the bidder's profit prospect and thereby increases the likelihood that the shareholders collect a takeover premium. From their perspective, the optimal amount of protection maximizes the expected takeover premium, that is, strikes a balance between a higher bid price in the event of a takeover and a lower probability of a takeover.

A closely related point is that minority protection aimed at restricting the dilution of minority shares does not serve as a screening device.[4] As shown in Box 1, better minority protection does not frustrate those bids where the bidder is the primary recipient of the takeover gains without discouraging even more those bids where the gains are more evenly shared.[5] Due to the free-rider behaviour, better protection raises the bid price for 'good' bidders (who bring large efficiency gains) and 'bad' bidders (who extract large private benefits). Since the profit margin of good bidders is typically smaller than that of bad bidders, better protection is more likely to discourage good bidders.

3.2. Bid incentives: The role of financial market and ownership structure

A different solution to the free-rider problem relies on acquisition of a stake before the tender offer is announced (Shleifer and Vishny, 1986). A bidder who already owns shares purchased at low prices can earn a profit even if all tendered shares are acquired at the full post-takeover value. Indeed, pre-takeover holdings are found to have a positive impact on bidder gains and on the success probability of takeovers (Burkart, 1999). The extent to which a bidder can accumulate an initial stake through secret open market purchases, however, depends on the market depth and the disclosure

Box 1. Bidder screening and minority protection

Within Grossman and Hart's (1980) tender offer game model we examine the notion that better minority protection can selectively frustrate those takeovers where the bidder enjoys large private benefits relatively to the security benefits. As we demonstrate by way of example this view is erroneous, and, if anything, the opposite holds.

[4] As shown below in Box 2, rules that impose a minimum price in a control transaction, such as the mandatory bid rule, can to some extent screen between bidders.

[5] This reasoning implicitly assumes that there is no competition among bidders. When multiple bidders compete for a target, bids and counterbids typically drive the price up beyond the level imposed by minority protection, making the latter a non-binding constraint.

Consider a firm with many small homogeneous shareholders (an atomistic ownership structure) and a bidder who does not own an initial stake. If the bidder gains control, he can generate proceeds V_R and can divert part of them as private benefits: let private benefits be $Z_R = \phi_R V_R$, so the security (non-private) benefits are $X_R = (1 - \phi_R) V_R$, under the bidder's control. (Security and private benefits under the incumbent management do not matter in the argument below.)

A successful takeover requires at least 50% of the voting rights and all shares carry the same number of votes. When confronted with an offer, the incumbent management is assumed to remain passive. The bidder makes a take-it-or-leave-it, conditional, unrestricted tender offer: he submits a price xB at which he buys the entire fraction x of tendered shares, provided that $x > 1/2$. In addition, making a bid entails fixed costs C, say due to searching for a target or due to preparing the bid. Thereafter the target shareholders non-cooperatively decide whether or not to tender their shares. Within this framework homogeneity of shareholders implies that if the bid succeeds all shares are tendered ($x = 1$).

A bid of B succeeds if it satisfies the free-rider condition $B \geq (1 - \phi_R) V_R$ and the bidder's participation constraint $X_R - B + Z_R - C \equiv (1 - \phi_R) V_R - B + \phi_R V_R - C > 0$. The smallest successful bid $B = (1 - \phi_R) V_R$ is optimal for the bidder, so the bidder gains control and makes a profit if $\phi_R V_R - C > 0$.

The ability ϕ_R to extract private benefits may depend not only on the characteristics of the bidder and/or target firm, but also on minority protection. To model this, let it be a declining function of the quality of minority protection: $d\phi_R(\lambda)/d\lambda < 0$ with higher values of λ corresponding to better protection.

Compare now the impact of legal protection on two bidders, 1 and 2, when considered in isolation (they do not compete for a target, but each bidder pursues a different target). Bidder 1 is better at extracting private benefits than bidder 2: $\phi_1(\lambda) > \phi_2(\lambda)$ for all λ. For simplicity, both can generate the same total proceeds $V_R = V_1 = V_2$. We refer to bidder 1 as the 'bad' (for shareholders) bidder, while bidder 2 is 'good'. Since the bad bidder is better able to extract private benefits, the post-takeover minority share value is lower under his control than that under the good bidder's control, that is, $(1 - \phi_1(\lambda)) V_1 < (1 - \phi_2(\lambda)) V_2$. Hence, the bad bidder can gain control at a lower price, making higher profits. Suppose that initially both bidders make a bid. An increase in λ forces both bidders to offer a higher price in order to induce shareholders to tender. This erosion of profits discourages the good bidder more, since his profits $\phi_2(\lambda) V_2 - C$ are smaller. In other words, the threshold value of λ at which the good bidder makes exactly zero profits is lower than that of the bad bidder. To the extent that improvements in minority protection have a different impact on different takeovers, this screening frustrates 'good' bids with high security benefits relative to the private benefits.

requirement. Once a bidder has disclosed his identity (and holdings), open market purchases have to be made at prices that tend to reflect the post-takeover share value, and become increasingly less attractive. Thus, by limiting the numbers of shares that a bidder can acquire before submitting a public tender offer, disclosure requirements affect the division of takeover gains. When choosing a disclosure threshold, a regulator faces again the trade-off between promoting takeovers and protecting minority interests. Lax disclosure standards allocate a larger share of the takeover gains to the bidder, thereby promoting an active takeover market. This, however, comes at the expense of those shareholders that sold their shares prior to the bid, thereby forgoing the takeover premium.

Instead of accumulating an initial stake through open market purchases, the bidder may seek out a large shareholder and negotiate a block sale. Even though the bidder has to surrender part of the subsequent takeover gains on the block to the incumbent blockholder, a block trade may be more profitable than accumulating a stake through secret open market purchases. Thus, the existence of large shareholdings facilitates takeovers relative to a firm with dispersed ownership. The blockholder's ability to promote a takeover by either selling or tendering his shares also allows him to prevent it by retaining his shares. Both increase with the block size, or more precisely with the associated number of votes, and an incumbent shareholder with a majority of the votes can unilaterally accept or reject a takeover attempt. This latter possibility has been a main concern in the debate on EU takeover regulation in those cases where a majority of votes is controlled with a much smaller proportion of the equity capital.

4. TAKEOVER REGULATION: STATUS QUO AND PROPOSALS

This section describes the regulatory framework governing control transfers at the member states level and provides a brief account of the attempts to regulate takeovers at the EU level, including the recommendations of the Winter Group and the Commission's draft directive (October 2002).

4.1. National regulation in Europe

In 1968, following several highly publicized takeovers, the UK introduced its self-regulatory City Code on Takeovers and Mergers, which has since been revised and expanded several times. The purpose of the code is to ensure fair and equal treatment of all shareholders upon corporate takeovers, and to provide an orderly framework within which takeovers are conducted. To this end, the code regulates the actions of bidders prior to the announcement of the bid, the content of the information issued to shareholders by bidder and target companies, and the defensive measures available to the target companies.

The City Code adopts strict versions of the mandatory bid rule and of defensive measure restrictions. It obliges a party who reaches through purchases the threshold

of 30% of the voting rights in a listed company to make an offer to buy the remaining shares. The price in the mandatory offer may be no less than any price paid within the preceding 12 months. And the code prohibits managers from taking defensive action without shareholder consent once an offer is made or seems imminent, explicitly forbidding the issue of retained shares and options, the sale or acquisition of assets of a material amount, and stipulation of contracts other than in the ordinary course of business.

Until the 1980s, takeover regulation remained essentially a UK (and US) phenomenon. In most Continental European countries, takeover bids were still so rare that special regulations were long thought to be unnecessary. Acquisitions occurred through negotiation between the acquirer and the target company's management, and transactions took place outside the public exchanges. In the second half of the 1980s, however, activity in European stock markets increased dramatically, as did the number of takeover bids targeted directly at the shareholders – in some cases with no prior negotiations at all, in other cases after negotiations had proved unsuccessful. Cross-border corporate takeovers also increased as wrestling control of companies in other countries through public takeover bids became more accepted.

In response to these developments most member states first adopted some form of self-regulation and later opted for binding legal rules, but some countries have maintained self-regulatory regimes. Table 1 offers a summary of these national regulations. All are strongly influenced by the British example, and the City Code has served as the standard in many areas such as information and disclosure, conduct during the offer, or competing offers (Hopt, 2002). However, as regards the mandatory bid rule and defensive measure some member states have opted for different provisions.

We see in Table 1 that almost all member states of the European Union have adopted some form of mandatory bid rule, either through self-regulation or by law, but the design of rules differs across jurisdictions. The UK has the most extreme form of mandatory bid rule that effectively prevents the acquisition of a controlling block at a premium. Continental European mandatory bid rules are typically less demanding, allowing either for a price discount or restricting the quantity of the outstanding shares that the rival is obliged to acquire (Ferrarini, 2002). The level of blockholding triggering a mandatory bid also differs across member states. Defensive measures by incumbents have also been regulated in most member states. In general, boards may only take such measures after approval from shareholders. In Germany, however, shareholders can approve measures in advance, in effect giving the supervisory board considerable leeway in responding to takeover bids.

In summary, national regulations within the EU have gradually converged to the UK rules, but there remain some differences as to the mandatory bid rule and the scope of the board to take defensive action, most notably in Germany. Overall, investor protection has probably been strengthened through the introduction of mandatory bid rules, at the expense of mobility on the market for control; but the increasing emphasis on shareholder approval of defensive measures has moderated this shift, and there is little evidence of a deregulatory 'race-to-the-bottom'.

Table 1. National and proposed supra-national takeover regulation in the EU

	Form of regulation	Mandatory bid rule condition	Restrictions on defensive measures
Austria	Legislation 1998	Legislation: 'control'	The board may only act in the interest of all shareholders, holders of other securities, the employees and the public at large
Belgium	1964 Soft law (rules and guidelines issued by the Banking Commission), legal rules	In the soft law of the 1970s: 'control', in the legislation 1989: 'control'	The board may not take action without shareholder approval (1990s)
Denmark	Self-regulation 1979, amended 1988, legislation 1995.		
Finland	Legislation 1989	67%	
France	Rudimentary self-regulation early 1970s, full takeover regulation by law 1989, amended 1992	In legislation late 1980s: 33% and 50% and at certain other occasions	The board may not take action without shareholder approval (1968)
Germany	Voluntary code 1995, legislation (the Takeover Act) 2002	Amendment to the voluntary code 1997: 'control', in the legislation 2002: 30%	The board may take actions only on the basis of shareholder authorisation, which could however be given in advance (1995 and 2002)
Holland	Self-regulation (primarily on mergers) in the early 1970s, proposal for takeover legislation envisaged 2002		
Italy	Stock Exchange Code early 1970s, Legislation 1992	Legislation 1992: 'control', later: 30%	The board may not take action without shareholder approval (1992)
Portugal	Legislation 1986	Legislation 1986: 33% and 50%	The board may not take action without shareholder approval (1986)
Spain	Legislation 1984, 1991	(Very complex)	(Very complex)
Sweden	Self-regulation 1971	Amendment to self-regulation 1999: 40%	The board may not take action without shareholder approval (1971)
UK	Self-regulation 1968	In 1968 code: 30%	
Failed takeover directive	Binding regulation	Weak mandatory bid rule, allowing national variation	Shareholders must approve defensive measures once a bid has been launched
Winter proposal	Binding regulation	Strict mandatory bid rule	Shareholders must approve defensive measures once a bid has been launched

Source: Official documents.

4.2. The US regulatory framework

The current European framework contrasts sharply with that of the United States, which features a dual regime with both federal and state laws. The principal federal legislation (the Williams Act) is aimed at procedural disclosure rules in the tender offer process. The Williams Act does not interfere with the power of a firm to resist a takeover bid under its corporate charter. But contrary to the EU, the US has a single, homogeneously defined standard on the accountability of a target firm's board, the so-called fiduciary duties, comparable to the well-established business judgment rule for management (Hopt, 2002). It is worthwhile noting that US federal regulation contains no mandatory bid rule. State laws vary considerably across the US. Many states have several anti-takeover statutes.[6] Delaware has only one, and is the only state with a well-developed case law on the use of defensive tactics. Mandatory bid rules only exist in Pennsylvania and Maine.

Defensive tactics are within the business discretion of the boards of directors and are widely used.[7] In fact, most Standard & Poor (S&P) 500 firms and a vast majority of those firms listed on the New York Stock Exchange (NYSE) or Amex are covered by several anti-takeover devices, ranging from poison pills, supermajority amendments to state anti-takeover laws (Burkart, 1999). Court challenges have also become an important defensive weapon in takeover bids, and hostile takeover activity dropped substantially in the US during the 1990s (Holmström and Kaplan, 2001).

Some states, particularly Delaware, have granted managers broad discretion in implementing takeover defences, on the basis of the so-called business judgment rule, and have been more successful in attracting incorporations. Regulatory competition has generally served the interests of incumbent management (Bebchuk *et al.*, 2002). Despite the variation in treatment across jurisdictions, the extent of regulatory competition should not be exaggerated. For most companies the choice has in effect stood between incorporating in Delaware or the company's home state. Moreover, state courts have acted in the shadow of possible federal intervention. The recent reaction in Congress to the spectacular governance failures in companies like Enron and WorldCom with the passage of the Sarbanes-Oxley Act also illustrates the latent threat of intervention from the legislator. On several occasions, most notably in the aftermath of the Great Depression, federal authorities propelled by political populism asserted theirs powers to break up corporate governance arrangements. Prior to these interventions ownership and control structures in the United States resembled those of present-day Continental Europe.

[6] There are five standard types of anti-takeover statutes: control share acquisition statutes, fair price statutes, business combination statutes, poison pill endorsement statutes, and constituency statutes (Bebchuk *et al.*, 2002).

[7] The board can, however, only act as a fiduciary of the shareholders and these strong fiduciary duties are upheld by the American courts (Hopt, 2002).

4.3. European Union level takeover regulation

The first attempts to harmonize takeover regulation in the EU date back to the early 1970s when the European Commission appointed Professor Robert Pennington to draw up a draft directive for takeover bids.[8] Like later drafts, this draft was strongly influenced by the UK City Code. It was discussed for a couple of years with representatives of the member states, but interest was limited, and eventually the project was abandoned. Ten years later the directive plans resurfaced and at the end of the 1980s the European Commission presented a proposal for a 13th Company Law Directive. The draft was widely criticized and interest among member states was once again limited.

However, in January 1988 the situation changed overnight when the Italian businessman Carlo de Benedetti extended a bid for a controlling stake in the giant Belgian holding company, Société Générale de Belgique. This cross-border bid started one of Europe's most controversial takeover fights to date. The battle involved numerous dubious defensive measures, and unveiled a considerable takeover regulation void at the European level, thus giving new impetus to the Commission's directive plans. At the urging of the European Parliament, the Commission in January 1989 presented a completed proposal for a takeover directive. The proposal triggered an intense debate. Strong objections were voiced against individual provisions, and many argued that a directive should be limited to certain basic principles for national rules while leaving details to national legislation. By the end of 1991, the Commission announced its intention to prepare yet another draft proposal, taking into account all such criticism.

The new proposal appeared five years later, in 1996. It was a proposal for a 'framework directive', containing general principles that member states would be obliged to follow when drafting their national takeover codes. To silence British opposition, member states would even be permitted to implement the directive through industry self-regulation. The proposal was amended several times, following comments from the first reading in the European Parliament, intense negotiations within the Council, and a protracted conciliation procedure with the European Parliament. The Council had also given in to German resistance on several substantive points, but there was one area where the willingness to compromise ran into a wall: defensive measures. The Council's common position stated that after a bid is announced such measures could only be enacted with the approval of the general meeting.[9] After extended negotiations the draft was finally submitted to the Parliament, which rejected it.[10] That outcome was surprising, because the proposed directive was crafted on the UK rules and this made it much more consistent with existing

[8] See Skog (2002) for a thorough account of the history of (attempted) takeover regulation at the EU level.

[9] German opposition was intense throughout this process. In the end Germany no longer backed the common position but was voted down, by 14 to 1, three times in the Council.

[10] Normally, the European Parliament plenary session votes on common positions reached after such extensive negotiation are little more than a formality. But during the discussion it became evident that differences in opinion split both the conservative and socialist camps, and that the vote would therefore be 'free'. In the end, Parliament rejected the conciliation compromise by the smallest possible margin of one vote.

national regulation than was the case in previous reform attempts. The directive failed because of the strong German opposition – based on a perceived asymmetry vis-à-vis the US where most firms are effectively shielded from hostile takeovers – against the restrictions in the board's discretion over the use of defensive measures.

Despite this defeat the Commission remained committed to the idea of a European takeover regulation. In September 2001 the Commission set up a 'High Level Group of Company Law Experts' under the leadership of Jaap Winter with the task of providing independent advice on issues related to the harmonization of European corporate law, including rules for takeovers. In January 2002 the Winter Group presented its recommendations on takeover regulation building on the rejected directive. As guiding principles for the creation of a level playing field the Group advocated shareholder decision-making and proportionality between risk-bearing capital and control. Applying these two principles, the Group made the following main recommendations:

(1) The price in a mandatory bid should be equal to the highest price paid by the bidder during the 6–12 preceding months. The mandatory bid should be made within a short period after control has been acquired. The exact definition of the 'level of control' is left for the member states to decide.
(2) The board of the target company must obtain prior shareholder approval before taking any frustrating actions once a takeover bid has been announced.
(3) A bidder who acquires 75% (or more) of the equity capital should be able to override any obstacle including voting differentiation[11] that prevents him from taking control over the firm (so called break-through rule). Furthermore, the bidder does not have to compensate the holder of shares carrying disproportionate voting rights or special control rights.
(4) Dual-class shares, voting caps, and other limitations to voting rights are to be voided in votes on defensive measures once a takeover bid has been announced.

Recommendations (1) and (2) endorsed the controversial provisions of the failed takeover directive, while recommendations (3) and (4) went much further, aiming at voiding a controlling minority shareholder's veto power on takeover bids. In addition, the Group recommended the introduction of the right for a majority shareholder to buy out minority shareholders (squeeze-out right), and of the right for minority shareholders to compel the majority shareholder to purchase their shares (sell-out right). As a threshold for triggering both squeeze-out and sell-out right, the Group proposed 90 or 95% of the equity capital.

In October 2002 the Commission presented a new draft directive. This proposal, the latest at the time of writing, shares its predecessors' scope and principles. But it

[11] Company-specific barriers that should remain outside the scope of the break-through rule are provisions restricting the transferability of shares, contractual barriers to takeover bids and pyramid structures.

also incorporates some of the recommendations made by the Winter Group. In particular, it introduces a squeeze-out right (with a threshold of between 90 to 95% of the equity capital) and a sell-out right, mandates bidders to pay the same price to controlling and minority shareholders, and retains the principle that shareholders have to approve defensive measures. Because of tremendous opposition and legal problems, the Commission did not include the break-through rule. The proposal, however, voids any restrictions on the transferability of shares and restrictions on voting rights against the bidder once a takeover bid has been announced. This new Article 11 removes a target firms' discretion to exclude a bidder from exercising his corresponding voting rights, say through voting caps, or to prevent him from purchasing further shares. In contrast to the break-through rule, differentiation of votes, that is, a multi-class security voting structure, is not considered to constitute such a restriction that is rendered unenforceable by Article 11.

5. CORPORATE GOVERNANCE

In this section we discuss the role of large controlling shareholders in corporate governance, and of the market for corporate control in contesting that role. It is important to clarify such matters before proceeding to assess the desirability of specific takeover regulations, as we do in the next section, because ownership concentration and takeovers interact with each other, and with more general economic and legal factors, in determining the effectiveness of corporate governance mechanisms.

Corporate governance research is concerned with how to allocate control over investment decisions and how to ensure that those entrusted with control use the resources efficiently. A critical aspect of any system of corporate governance is control *contestability*, that is, the means through which control may be removed from an incumbent manager or controlling owner. Contestability is important *ex post*, because it allows control to be reallocated to more efficient agents. But it is also important *ex ante*, because potential takeovers affect the behaviour of those entrusted with control. In general, collective action problems limit the extent to which dispersed investors can monitor management behaviour. Not only hostile takeovers, but also managerial compensation schemes, shareholder litigation, and monitoring by creditors, in particular banks, can promote efficiency (for surveys see Shleifer and Vishny, 1997; and Becht *et al.*, 2002). In the European context, large blockholder monitoring plays a particularly important role, and we discuss it next in some detail.

5.1. Costs and benefits of large shareholders

An investor holding a substantial equity stake has incentives to engage in information acquisition and monitor management, and also has considerable power to put management under pressure, thereby partially overcoming the collective action problem among dispersed shareholders (see Becht *et al.*, 2002). Starting with Demsetz and

Lehn (1985), numerous empirical papers examine the relationship between ownership concentration and firm value/performance for a given country, typically the US (for a survey see Holderness, 2002). The recent law and finance literature has broadened this debate by analysing this relationship across different countries' legal regimes. In support of the view that large shareholders play a positive role, large shareholdings are found to be associated with higher turnover rates of CEOs and directors, with lower compensation for top management, and with lower levels of discretionary spending, such as advertisement (Denis and McConnell, 2002; Holderness, 2002). However, the empirical evidence on the effectiveness of 'shareholder activism' in the US finds a negligible impact of large institutional owners (Becht *et al.*, 2002). Overall, the international evidence indicates that ownership has most often a positive impact on firm value and that this relationship varies both by blockholder identity and by country (Denis and McConnell, 2002). As regards the latter, ownership concentration is found to have a stronger positive impact on firm performance in countries with less legal investor protection.[12]

Concentrated ownership, however, also entails costs. Indeed, large shareholders can abuse their power to extract more benefits possibly at the expense of the small shareholders (Shleifer and Vishny, 1997).[13] Not all benefits accruing from controlling a firm can be written into a contract and enforced in a court. These so-called private benefits of control, as distinct from the contractible security benefits, can come from many sources. They may come from making decisions that benefit a particular investor (or management) at the expense of other investors. Alternatively, they may stem from the power, prestige and influence over social and political events that are associated with control of an important firm. Demsetz and Lehn (1985) propose the term 'amenity potential' for this latter type of private benefit: it does not dilute the claims of other investors and can increase total investor utility, but may distort managerial decisions and prevent value increasing control shifts from taking place.

Empirically, the size of private benefits and the extent to which they come at the expense of firm value are both controversial. One method to quantify these benefits is to measure the difference between the per share price in the sale of a controlling block and the share price after the announcement of the block trade. Applying this method, Dyck and Zingales (2001) document 412 transactions of a controlling block in 39 countries. In some countries private benefits, by this measure, appear to be very large. For example, 11 Brazilian transactions show an average premium of around 65%, while in the United States and Canada this figure is 2%. In Europe the range of variation is somewhat smaller, but in Italy and Portugal the mean premium were

[12] Burkart *et al.* (2002) show in a unified model of managerial succession how family control emerges in regimes with weak legal shareholder protection and widely held firms in regimes with good legal protection.

[13] Other costs associated with (partial) ownership concentration are reduced risk sharing, reduced market liquidity, excessive risk taking in highly leveraged firms, or *ex post* expropriation of managerial rents thereby stifling initiative *ex ante* (Becht *et al.*, 2002).

37 and 20%, respectively, as compared to most other European countries with mean premia below 10%.[14] The authors' interpretation is that these large valuations of private benefits reflect possibilities to steal assets from companies, but they cannot rule out that amenity potential is involved as well. In both interpretations, non-contractible private benefits play an important role for the incentives of managers and possibly large blockholders. The size of these benefits appears to be inversely related to the extent to which a country's legal rules protect minority investors (LaPorta *et al.*, 1997 and 1998), and the accumulation of control rights in excess of cash flow rights – whether through dual class shares, pyramids or cross-holdings – empirically appears to decrease share value, suggesting that private benefits are extracted at the expense of small shareholders (Denis and McConnell, 2002).[15]

To sum up, controlling shareholders can be effective monitors, but they can also extract private benefits at the expense of other investors and stakeholders in the firm. Similarly, large equity ownership by managers also gives rise to two conflicting (alignment and entrenchment) effects. On the one hand, it aligns the interests of the manager with those of the other shareholders, thereby leading to better performance. On the other hand, larger equity stakes let managers pursue their own goals, possibly at the expense of other shareholders. Both types of ownership concentration effects are well documented in numerous empirical studies, which often do not distinguish between ownership by managers and outside blockholders. The empirical evidence is inconclusive on whether the positive or negative effects of ownership concentration dominate. Furthermore, ownership concentration is found to be much more prevalent in countries with weaker legal protection even though the agency conflict between large and small shareholders is exacerbated in these countries.

5.2. Takeovers and management contestability

An important aspect of a corporate governance system is the extent to which it allows control transfers. Circumstances may and do arise when a change of control is efficient, for example because the current CEO proves unable or unwilling to adjust to a new environment. The most direct way to achieve contestability is through an active market for corporate control. A functioning (hostile) takeover market subjects firms to a continuous auction process: whenever an outside party is able to improve the value of existing corporate resources, it can bid for the firm's control and replace

[14] Measures of private benefits using the control premium should be treated with considerable care since the size of the premium depends on many things such as the inequality of voting power, the extent of competition in the market for corporate control, the size of the block sold, and the distribution of shares in the target firm. The average premium also varies over time within countries, in ways that are hard to explain (Becht *et al.*, 2002).

[15] The conflict between controlling blockholder and minority shareholders may be mitigated by the presence of additional blockholders. A second or third blockholder can provide monitoring or prevent collusion between controlling blockholder and management. See Lehman and Weigand (2000), Volpin (2002), Faccio *et al.* (2001) for empirical evidence of such mechanisms.

incumbent managers. In addition, the mere threat of a takeover affects the behaviour of those entrusted with control, that is, it disciplines them.[16]

The importance of contestability, however, depends on the character of the governance system, in particular whether control is exercised by a controlling investor, who values the option to sell to a more efficient party, or by managers of widely held firms, who have nothing to sell. And contestability can entail costs if takeovers are triggered by the managers' ability to pursue their own interests at the expense of the shareholders.[17] Similarly, the threat of a takeover may exacerbate agency problems if, instead of disciplining managers, it induces them to undertake manager-specific investments that make them less easily replaceable. And the prospect of being fired without proper compensation for current private benefits may undermine the manager's willingness to invest long-term human capital in the firm, and shareholders may worry about dilution of their claims in connection with the sale or under new management.

Ultimately, the degree of contestability of controlling owners and managers depends on interaction of all the mechanisms of the corporate governance system. As noted above, contestability may also come at the expense of minority shareholders, as the level of minority protection affects the costs of taking over a firm. The benefits of contestable control rights must be weighed against any loss of incentives to engage in entrepreneurial activities or large shareholder monitoring.

6. CORE TAKEOVER PROVISIONS: AN ECONOMIC ANALYSIS

In this section we examine the three regulatory measures that are at the centre of the takeover regulation debate. We first briefly review the familiar arguments in favour of the principle that shareholders have to approve defensive measures, then we analyse the mandatory bid rule and the break-through rule, showing how they interact with each other and how their combined effect depends on the characteristics of both bidder and target firm. Three boxes provide a more formal treatment of the arguments, based on insights from Bebchuk (1994) and Burkart *et al.* (2000).[18]

[16] Of course, a control transfer can also be efficient simply because the controlling party wishes to sell, for example because of lifecycle consumption reasons, or lack of a family successor. This motive also gives an important efficiency-enhancing role to a liquid control market, in that liquidating one's investments encourages entrepreneurial activity. The US venture capital industry illustrates the importance of the possibility to exit (liquidate) investments. Venture capitalists realize the returns on their investments through private sales of the venture to another firm or through initial public offerings and subsequent open market sales. The prospect of such exits is crucial for the young firms' ability to attract venture capital in the first place.

[17] See Burkart (1999): empirically, managers who own an equity stake and therefore gain financially from a successful takeover resist takeovers less; and most takeovers are undertaken not by corporate raiders, but by firms headed by professional managers.

[18] Bebchuk (1994) compares the incidence of majority block transactions in the absence of the mandatory bid with the incidence of such control transfers in a regime with the mandatory bid rule. Burkart *et al.* (2000) analyse a bidder's choice between a negotiated block trade and a tender offer when attempting to gain control over a firm with a dominant minority shareholder.

6.1. Takeover defences

Many view takeover defences as an entrenchment device that allows managers to protect their private benefits at the expense of the shareholders: by making bids more costly, defensive measures reduce the number of takeovers and hence the disciplinary force of the market for corporate control. Others argue that defensive measures reinforce the bargaining role of management. When shareholders are numerous and lack coordination, they need the management to negotiate on their behalf. Providing the management with the power to defend the company benefits shareholders. It prevents coercive bids and by delaying an initial bid it provides the necessary time to generate competition among bidders, once a company has come into play. Accordingly, the increase in the bid premium due to defensive measures dominates the negative deterrence effect, that is, the reduction in the probability of a bid. Empirical evidence on takeover defenses does not resolve the debate. First, it is not possible to observe how many takeovers have been prevented by defensive measures. Second, the evidence on the deterrence effect is inconclusive (Becht *et al.*, 2002).

When analysing defensive measure it is important to distinguish between the impact of defensive measures and the power to undertake them. Takeovers may potentially be disruptive for the pursuit of long-term profitable strategies, but shareholders should take this into account when accepting or rejecting a particular bid or when voting on defensive measures. The conflict of interests between managers and shareholders is well documented in the empirical literature (Shleifer and Vishny, 1997). This conflict is particularly pronounced in takeovers: the turnover rate for top managers significantly increases following the completion of a tender offer, and those managers who lose their jobs have difficulties finding another senior executive position (for a survey, see Burkart, 1999). If a manager can apply defences without shareholder ratification, he may abuse this discretion in order to secure his position. Although it is difficult to distinguish personal motives from bargaining on behalf of the shareholders, evidence suggests that managers resist to protect their private benefits. For instance, managers seem less inclined to resist when they gain financially more from a successful bid. Consequently, shareholders need to supervise the manager's defensive actions closely, if they want to ensure that these are indeed taken in their interest. Shareholder control is surely improved by giving them the authority over takeover defences. Thus, defensive measures should be subject to shareholder approval.

Article 11 of the current draft directive rules out ceilings on shareholdings (for bidders) and restrictions on the voting rights of already purchased shares. This provision is consistent with the reasoning above, and with the principle of shareholder decision-making. It removes the discretion of management to veto share purchases by any (potentially) hostile bidder or to limit his voting rights. In fact, the rule goes further. It also deprives management of the possibility to try to convince all other shareholders to adopt such restrictions against a bidder. Restrictions on transferability and voting rights are rendered unenforceable.

6.2. Mandatory bid rule

In the absence of the mandatory bid rule, a controlling minority shareholder (or 'incumbent') may sell his block at any price that an outside buyer (or 'rival') is willing to pay. Also, the rival has no obligations to let minority shareholders participate in the control transaction. Hence, such a block sale takes place whenever it is mutually beneficial for incumbent and rival. Due to the free-rider behaviour, small shareholders are not willing to sell their shares for less than the value of the share after the block trade. Consequently, the rival does not gain from making a voluntary tender offer and merely acquires the controlling block.[19]

We show in Box 2 that such control transfers necessarily benefit both incumbent and rival, but may have a positive or negative impact on the (wealth of the) small shareholders. When the incumbent's private benefits are relatively small compared to the rival's private benefits, a control transfer can be mutually beneficial even if the loss in security benefits exceeds the gains in private benefits. Similarly, when the rival's private benefits are relatively small compared to the incumbent's private benefits, incumbent and rival may not want to trade the block even though a control transfer would be value increasing.

The mandatory bid rule proposed by the Winter Group and the Commission in its latest proposal requires the rival to offer small shareholders the same per share price as he has paid the incumbent in the block trade. In such an environment, a control transfer takes place only if the rival creates sufficient added value that enables him to pay the control premium also to the small shareholders. Due to the redistribution from rival to small shareholders, the mandatory bid rule has two opposing effects (for details see Box 2). On the one hand, it prevents any value decreasing change of control, and if a control transfer takes place all parties gain, including the minority shareholders. The mandatory bid rule forces the rival to internalize any negative externality that a control transfer may have on the shares owned by the small shareholders. Consequently, he is never willing to acquire the firm, unless a control transfer is efficient. On the other hand, the mandatory bid rule increases the likelihood that a value increasing control transfer fails to take place. Having also to pay the control premium to the small shareholders can inflate the total purchase price beyond the rival's willingness-to-pay, even though a control transfer would add value. Thus, the mandatory bid rule can also impose losses, that is, forgone share value improvements, on the small shareholders.

Which of the effects dominates is an empirical question. For the US, empirical studies find that trades of large blocks (and block formations) are on average associated with abnormal share price increases. While the market appraisal of block transfers is more favourable for trades followed by a full acquisition, cumulative abnormal

[19] One reason why a rival may nonetheless prefer to acquire all shares is to transfer losses and profits between firms to minimize his tax obligations, rather than pay taxes separately on each firm's profit (Bergström *et al.*, 1994).

Box 2. Mandatory bid rule and control transfers

Presuming the existence of a controlling minority shareholder, we analyse the impact of the proposed mandatory bid rule. To this end we identify, within a generic control transfer model like those of Grossman and Hart (1980, 1988) and Bebchuk (1994), the conditions under which a control transfer takes place in a regime with and without a mandatory bid rule.

Consider a firm with a large incumbent shareholder who holds the majority of votes and owns a fraction α of the return rights (shares), that may be less or more than $1/2$. The remaining $1 - \alpha$ shares are dispersed among small shareholders. The firm is approached by an outside investor, a 'rival', who wants to gain control by acquiring a majority of votes. Denote by X_I (X_R) the security benefits under the control of the incumbent (rival), and by Z_I (Z_R) the incumbent's (rival's) private benefits of control. These parameters are publicly known. Finally, we define a control transfer as value increasing (decreasing) when $X_R + Z_R > X_I + Z_I$ ($X_R + Z_R < X_I + Z_I$).

In the absence of the mandatory bid rule, a necessary and sufficient condition for a control transfer is $X_R + Z_R/\alpha > X_I + Z_I/\alpha$. This condition does not imply efficiency, nor does efficiency imply it. When $X_R + Z_R < X_I + Z_I < X_I + Z_I/\alpha < X_R + Z_R/\alpha$ an inefficient control transfers occurs, while an efficient control transfer fails to take place when $X_I + Z_I < X_R + Z_R < X_R + Z_R/\alpha < X_I + Z_I/\alpha$.

Consider now the regime with the mandatory bid rule that requires the rival to offer incumbent and small shareholders the same per share price. Since the incumbent sells his stake only if he gets at least compensated for both forgone security benefits αX_1 and private benefits Z_I (control premium), the rival has to pay at least $X_I + Z_I/\alpha$ for the entire firm. Hence, the condition for a block trade and a subsequent bid taking place is $X_R + Z_R > X_I + Z_I/\alpha$. In this case control is transferred, and the mandatory bid rule redistributes part of the takeover gains from the rival to the small shareholders, unless $X_R > X_I + Z_I/\alpha$ in which case the mandatory bid rule has no effect.

Since the condition $X_R + Z_R > X_I + Z_I/\alpha$ implies that $X_R + Z_R > X_I + Z_I$ holds, the mandatory bid rule prevents all value decreasing control transfers. But the mandatory bid rule also blocks more value increasing control transfers as the condition for a control transfer is $X_R - Z_I > Z_I/\alpha - Z_R$ rather than $X_R - X_I > (Z_I - Z_R)/\alpha$. These two conflicting effects are both diluted under a less stringent version of the mandatory bid rule: if some discrimination is allowed between per share price in the block trade and the tender offer, fewer value increasing control transfers are frustrated, but some value decreasing transfers are not prevented.

returns are also positive when no subsequent full takeover occurs (Holderness, 2002). These findings seem to refute the claim that block trades are undertaken with the purpose of looting companies at the expense of small shareholders. Even though small shareholders are harmed in some transactions, the average share value increases suggest that improved management is the primary source of gains in block trades.[20] Thus, large as well as small shareholders benefit from the absence of a mandatory bid rule. But whether this holds more generally can only be established through further empirical work.

6.3. The break-through rule

A novel and economically interesting contribution of the Commission's Winter Group recommendations was the break-through rule, enabling an investor who holds a certain fraction or more of the equity capital to break through the firm's existing control structure and exercise core control rights, such as replacing top management. With the proposed threshold of 75%, the rule would imply that current controlling minority shareholders who own less than 25% of all shares lose their veto power over a control transfer. Bennedsen and Nielsen (2002) identify how many firms in the EU (except for Greece, Luxembourg, and the Netherlands) would be affected by the proposed break-through rule. In their sample of 5126 publicly traded European firms 20% have dual (multiple) class shares. In 3–5%, or 33–49 of the firms with dual class shares, controlling owners would lose their veto power over a control transfer if the break-through rule were to be applied. In addition, a large number of firms with controlling blocks close to the 25% threshold would potentially be affected when issuing equity. These firms are mainly from Denmark, Germany, Italy and Sweden, and many belong to the group of the largest European firms.

The formal analysis in Box 3 examines how and when a controlling minority shareholder is ousted by an outside rival in a regime with a break-through rule. While the subsequent discussion presupposes a firm where the proposed break-through rule eliminates the controlling shareholder's veto power over a control transfer, much of the analysis is also applicable to firms with non-controlling minority owners. Control or substantial influence over a firm does not necessarily require a majority of votes. In particular, when the remaining shares are dispersed, a minority block may be sufficient. For instance, neither the Ford nor the Wallenberg families own a majority of voting shares.[21]

[20] The reported gains to small shareholders, however, do not imply that a control transfer through a block trade is to be preferred to a control transfer through a tender offer (Burkart *et al.*, 2000).

[21] In the sample of Bennedsen and Nielsens (2002), 17% of the firms with dual class shares have a dominant minority shareholder, who holds (at least) ten times as many voting rights than cash flow rights without possessing the majority of votes. Among these firms, a significant number are European top-500 firms, such as Fiat and Ericsson. The introduction of the break-through rule would considerably weaken the position of the dominant shareholder.

Box 3. Break-through rule and control allocation

In a regime with both break-through and mandatory bid rules a buyer has a choice when trying to take over a firm controlled by a minority shareholder. He can buy the block and then offer to buy the remaining shares on the same terms from the small shareholders. Alternatively, he can bypass the controlling minority shareholder by making a public tender offer. To illustrate the break-through rule, we consider the same model as in Box 2 but restrict the block α of the incumbent (who still holds the majority of votes) to be less than 25%.

Suppose the rival makes an unrestricted offer conditional upon receiving at least 75% of the equity capital, which under the break-through rule would secure him the majority of votes. Since each small shareholder does not perceive himself pivotal for the tender offer outcome, small shareholders tender if the bidder offers (at least) a per-share price $b = x_R$ where x_R denotes the per-share security benefits under the rival's control. Thus, a bid $b = x_R$ succeeds, irrespective of the incumbent's tendering decision. The only possibility for the incumbent to prevent the control transfer or to increase the takeover price is to make a counter-bid. In the simple setting where the incumbent can make a single counter offer after the rival made his single offer, the incumbent's maximum willingness-to-pay corresponds to his valuation of the entire firm $X_I + Z_I$. Accordingly, the incumbent counterbids if the rival offers per-share less than $x_I + z_I$. Anticipating the incumbent's strategy, the rival either makes a bid $b = \min\{x_R, x_I + z_I\}$ and wins control, or does not bid.

Instead of bypassing the incumbent, the bidder can buy the controlling block and subsequently make a bid to the small shareholders. As shown in Box 2, this acquisition strategy implies a per-share price of (at least) $b = \min\{x_R, x_I + z_I / \alpha\}$ which is (weakly) larger than the bid price necessary to win the bidding contest. Consequently, the rival prefers to use the break-through rule. This in turn forces the incumbent to compete for control, and the rival wins control only if a control transfer is value increasing. (The rival does not bid when he would lose the contest, and in that case the incumbent retains control.)

Thus, the break-through rule ensures that all and only value increasing control transfers take place. In particular, it ensures feasibility of value increasing control transfers that would otherwise fail because of the incumbent's private benefits ($X_I + Z_I < X_R + Z_R < X_R + Z_R/\alpha < X_I + Z_I/\alpha$) or because of the mandatory bid rule ($X_I + Z_I < X_R + Z_R < X_I + Z_I/\alpha < X_R + Z_R/\alpha$).

It is important to note that the break-through rule implies efficient control allocation only in the absence of wealth constraints. If the incumbent is unable to finance a counter-bid, the break-through rule has less attractive properties: most notably, the rival can gain control with a bid $b = x_R$, irrespective of whether or not the control transfer is value increasing or decreasing (see Box 4).

By making a firm with a controlling minority shareholder akin to a firm with dispersed ownership for which incumbent and rival compete, the break-through rule indeed facilitates the transfer of control, as intended by the Winter Group. Intuitively, the break-through rule gives the rival the option of bypassing the incumbent to take control of the firm rather than seeking his agreement. Since the negotiated block trade with subsequent mandatory bid is the more expensive mode of gaining control, the rival will always choose to circumvent the incumbent and directly make a tender offer. This leaves the incumbent with no other possibility than to compete if he wants to retain control. Hence, provided that rival and incumbent can finance bids equal to their valuation of the entire firm, the party with the higher valuation prevails. Thus, in the absence of wealth constraints, the break-through rule ensures an efficient allocation of corporate control. It seems plausible to assume, however, that many – if not all – incumbent controlling minority shareholders are financially constrained. If not, they could regain their veto power over a control transfer by increasing their block above the 25% threshold. Once wealth constraints are taken into account, control allocation need no longer be efficient in a regime with the break-through rule.

When assessing the merits of the break-through rule, it is important to consider the reasons why value increasing control transfers may fail in the first place. As shown in Box 2, large private benefits of the incumbent can prevent efficient control transfers. The Winter Group seems rather biased to focus on this explanation and to view controlling minority shareholders as the major obstacle to takeovers and corporate restructuring in Europe. However, the mandatory bid rule (in the most stringent form), also part of the Group's recommendations, is also a reason why value-increasing control transfers can fail. The break-through rule does not only allow the rival to bypass the incumbent but also spares him the cost of having to pay all small shareholders a control premium. That is, the break-through rule makes value increasing control transfers feasible that are frustrated either by the incumbent's opposition or by the mandatory bid rule. Hence, if promoting an active takeover market is a primary objective one may argue in favour of a regime that combines break-through rule with no or a less stringent mandatory bid rule.

When the incumbent cannot compete with the outside rival for control, the break-through rule also has undesirable effects for the small shareholders, as the analysis in Box 4 establishes. Most notably, the break-through rule can undo the added (minority shareholder) protection that the mandatory bid rule provides. It enables the rival to gain control with a bid equal to the post-takeover (minority) share value, thereby putting small shareholders in the same position as in a regime without the mandatory bid rule. Furthermore, a bid can succeed even though it is against the shareholders' collective interests, due to the same coordination problems that can cause the failure of value increasing takeover bids when each shareholder prefers to 'free-ride' and get the entire value improvement. Coordination problems can lead to the failure of value-increasing bids and, symmetrically, to success of value-decreasing bids.

Box 4. Break-through rule and minority protection

In Box 3 we saw that the break-through rule provides the rival with a cheaper acquisition mode than the negotiated block trade with subsequent mandatory bid. Accordingly, the break-through rule redistributes the takeover gains from the incumbent controlling minority shareholder to the rival. But small shareholders may also be among the losers. Consider, for instance, a situation where the rival gains from taking control through a negotiated block trade and subsequent mandatory bid ($X_R + Z_R > X_I + Z_I/\alpha$). In this case, the break-through rule enables the rival to gain control with a per-share price $b = x_I + z_I$ rather than $b = x_I + z_I/\alpha$, lowering also the small shareholders' return.

More important in terms of minority protection is the likely scenario where the incumbent is financially constrained and unable to compete for control. In this case, the break-through rule enables the rival to gain control with a bid $b = x_R$. This, however, is exactly the value of the minority shares following a block trade in the absence of the mandatory bid rule. Thus, the small shareholders are in the same position in a regime without the mandatory bid rule as in a regime with the break-through rule when the incumbent is unable to compete. Nonetheless, small shareholders may still benefit from the break-through rule as they may gain from a block trade.

Furthermore, if the incumbent is financially constrained, the break-through rule makes possible value decreasing control transfers that would be prevented if only the mandatory bid rule were imposed. Small shareholders accept a bid $b = x_R$, and gain from doing so, also when the increase in security benefits is less than the loss in private benefits ($X_I + Z_I > X_R + Z_R > X_R > X_I$). Thus, leaving the takeover decision in the hands of the small shareholders does not guarantee that value decreasing control transfers necessarily fail.

In addition, coordination problems among small shareholders allow for the possibility that a control transfer takes place even though it neither benefits the incumbent, nor the small shareholders, nor is it value increasing. Thus, the break-through rule re-introduces problems associated with takeovers of widely held firms (Grossman and Hart, 1980), in particular the concern that shareholders tender to avoid holding a 'low-value minority share'. A noteworthy feature of the 'free-rider' behaviour is that the current or pre-bid share value does not enter the tendering decision. Tendering is the rational choice for each individual shareholder whenever the bid price at least matches the post-takeover share value. This holds independently of the size (and sign) of the share value change following the takeover. Thus, a bid $b \geq x_R$ can succeed even though it is against the small shareholders' interests ($X_R < X_I$), because it is individually rational to hedge against the unfavourable minority position (success and failure of a value decreasing bid are both Nash equilibrium outcomes). One may dismiss the success of value decreasing bids as a highly unlikely outcome. However, the rationale for rules aimed at protecting shareholder interests such as banning restricted bids must ultimately be the endeavour to avoid such undesirable outcomes, caused by the coordination problem among dispersed shareholders.

The break-through rule is clearly against the interests of the incumbent controlling minority shareholders; it eliminates their veto power over a control transfer and reduces the prospect of getting compensated for the forgone private benefits in a control transaction. As a result, controlling blocks with less than 25% of the equity capital will (drastically) lose in value. This loss will be reflected in smaller (or even zero) price differentials between shares with high voting power and shares with low voting power and lower premium paid in block trades to the extent that such transactions continue to take place (without triggering a mandatory bid). It also seems likely that controlling minority shareholders respond to the introduction of the break-through rule and try to circumvent it. One way to undermine the break-through rule is the approval of defensive measures in a general shareholder meeting. By virtue of owning a majority of the votes, the controlling minority shareholder can de facto unilaterally decide to frustrate a bid. The Winter Report's proposals shut down this option by prohibiting the use of disproportionate control rights in votes on defence measures.

As already mentioned, raising the block size above the 25% threshold is the most straightforward way to neutralize the break-through rule, provided that the necessary funds are available. According to the estimates of Bennedsen and Nielsen (2002), this strategy is within reach for very few firms in Continental Europe. However, adding layers to pyramidal control structures, enhancing cross-shareholdings, and other devices for separating ownership and control are alternative means to avoid the risk of becoming a victim of the break-through rule. In fact, the Winter Group explicitly acknowledges that pyramids and dual class shares serve the purpose of keeping control with little equity capital, but recommends that the break-through rule should not apply to pyramids because it would be too complicated and expensive. Hence, the Report has been criticized for exempting or even promoting pyramids, thereby affecting existing corporate governance arrangements asymmetrically (Bebchuk and Hart, 2002).

Bennedsen and Nielsen (2002) point out that the introduction of the break-through rule may also have an impact on firms in which the controlling minority shareholder currently owns more than 25% of the equity capital. At least some of these firms are likely to be restricted in raising new equity capital without falling under the break-through rule. For such firms the break-through rule may well increase the cost of new funds or limit its availability.

Finally, it should be noted that the break-through rule would represent a major *ex post* intervention in the property rights of controlling minority shareholders. Such interventions raise, besides fundamental fairness issues, the prospects that there will be more in the future, thus creating uncertainty about the basic property rights. In terms of our analysis this would undermine the incentives to hold controlling blocks in the first place.

7. WHICH TAKEOVER REGULATION FOR EUROPE?

The impact of specific regulation differs fundamentally across countries in Europe, largely due to the differences in the predominant patterns of ownership and control

in individual firms. The mandatory bid rule and the break-through rule have no impact when a firm's shares are widely dispersed. The two rules have opposite effects when ownership and control are concentrated, more precisely when there are controlling minority shareholders with less equity than the threshold for a break-through rule and the controlling owner is wealth-constrained. If only the mandatory bid rule is binding, it will increase entrenchment. A controlling owner who uses dual-class shares to separate ownership and control may well respond to the break-through rule by forming a more effective control pyramid, and entrench further. We saw that as many as one-fifth of all listed firms in Europe used shares with differentiated votes (Bennedsen and Nielsen, 2002). In a substantial number of these firms, the controlling owner would incur control losses without receiving any compensation. And an even larger group of firms would be constrained in raising equity because their control block would otherwise fall below the break-through threshold.

More generally, as our analysis has demonstrated, there are also obvious limits to what can be achieved through takeover regulation, in any system. Takeover decisions do themselves suffer from agency problems, in fact takeovers may be as much manifestations of agency problems as solutions to them. Takeover regulation affects the distribution of the takeover gains among the bidding firm and the target firm, and between a controlling owner and minority shareholders in the target, and thus the incentives to make bids. But it is not possible to screen out bad bids (primarily motivated by control benefits) without also preventing value enhancing bids. Measures to protect minority investors in takeovers increase the costs of taking over, thus reducing contestability.

It is not easy to ensure contestability in a corporate governance system like that of Continental Europe. Large controlling stakes imply that hostile bids are unlikely to succeed, and managerial compensation schemes are unlikely to provide suitable incentives when a powerful controlling shareholder can easily fire management. Similarly, the board of directors cannot be expected to play the same independent function as in a widely held firm, because the members sit there on a mandate from the controlling owner. We will return to what could possible be achieved through other mechanisms, such as institutional investor monitoring, litigation and media.

Moreover, takeover regulation would increase the discretion of managers to the extent that it discourages monitoring by controlling shareholders. To evaluate takeover regulation, one needs to compare not only the costs and benefits of controlling shareholders, but also the costs and benefits of a possible alternative: the managerially controlled firm. The evidence on the relative performance of firms with controlling owners and those with dispersed shareholders does not yield conclusive results (Becht *et al.*, 2002). This should not come as a surprise, given the strong interrelationship between competition, the firm's internal organization and ownership concentration. Moreover, as we discussed, such comparisons are extremely difficult since the effects of particular ownership and control structures depend critically on the entire corporate governance system.

Comparisons at the level of systems also do not yield clear results. The study by Dyck and Zingales (2002) on control benefits using premia in block transactions suggests substantial variations across countries, but the differences are rather small among developed market economies. Examinations of managerial dismissals following shocks to earnings, cash flows, and stock prices suggest no significant differences across countries (Kaplan, 1997). However, the mechanisms through which turnovers of management are achieved differ fundamentally. In Japan, for example, the company's house bank becomes more active, while in the United States board activity increases.

Intervening in corporate governance systems is risky precisely because of the interrelationship between the different mechanisms. If large shareholder monitoring is effectively shut down, it will take time before the other mechanisms adjust. For example, transparency about ownership and control structures and about what owners and managers do is still much poorer in many European countries than in the US. The tradition of litigation is very different, and the courts have a rather limited role in resolving corporate governance issues in Europe.

7.1. Takeover regulation and the internationalization of finance

Of course, the reference point for any regulatory effort in the area of takeover regulation and corporate governance should be contractual freedom. Any intervention must be clearly motivated by externalities stemming from corporate governance failures in individual firms. Even more important, legally signed contracts should be respected. Extraordinary circumstances may require altering contractual rights in existing contracts, as was the case in the 2001 Sarbanes-Oxley US legislation which, in the aftermath of the Enron and other accounting scandals, strengthened the liability of managers and owners for their financial statements. But these interventions risk creating uncertainty about the basic rules and thus undermine the willingness to engage in entrepreneurial activity and invest in companies. Even when regulation is warranted, self-regulation has proven effective in many countries, with the UK City Code as a very prominent example.

However, internationalization and potential contagion effects from governance failures in individual firms or exchanges suggest that government intervention is warranted, and that it may be implemented in various forms at both national and supranational levels. As we have seen, the UK regulation has served as the model for national and EU-level regulators in Europe. But there are at least two alternative regulatory frameworks.

One model is that of the US with its predominance of firms with dispersed shareholdings and considerable variation in corporate laws across states. Potential competition among jurisdictions plays some role in shaping regulation over time, and Delaware has emerged as the state par preference for large listed corporations. In the EU context the US model would imply an EU-level securities markets regulator and

subsidiarity in most aspects of corporate law, but with one or two national jurisdictions emerging as the major attractors for large firms.

A second alternative model is that of Canada where corporate law also is state-based but considerable coordination takes place at the federal level. The Canadian example combines a regulatory framework requiring a high level of transparency *à la* US with a corporate governance system dominated by concentrated shareholdings and extensive separation of ownership and control through pyramiding and differentiation of votes. Minority protection comes primarily from a commonly used general clause against oppression of minority interests. Interestingly, Canada had the same low level of control premium as the United States in the Dyck and Zingales (2002) study. The Canadian model would also allow variation across EU member states but with extensive coordination at the EU level. For Continental European and Nordic countries reluctant to fundamentally change their system of corporate governance, the Canadian experience offers an interesting alternative to a European framework based on the US and UK experiences.

7.2. Harmonization and heterogeneity

Our analysis suggested that harmonization has important downsides, in particular when rules have a very different impact in different countries. So, binding EU directives in this area are clearly problematic. However, the ability to freely buy and sell control across national borders is an important aspect of the single market, and these border-transcending aspects of takeover regulation should be the focus of the European Commission. Much of what is in the current draft directive has this focus, but the strict mandatory bid rule has a broader impact and goes against the objectives of contestability and a level playing field. We would argue in favour of an EU framework for takeover regulation that balances the benefits and costs from harmonization, recognizing the differences in corporate governance systems and the different impact of individual pieces of regulation. Such a framework would contain both binding directives and recommendations. But what should the recommendations offer, and what elements should possibly be binding?

In some areas there are already binding rules, in particular when it comes to disclosure of ownership and control. But careful examination shows that in many countries this regulation is only implemented superficially (Barca and Becht, 2001). It is often very difficult to get access to the relevant information and even when this information is available the data provided is not sufficient to understand the control structure. Disclosure of ownership and control is critical to the market for corporate control and for monitoring the activities of controlling shareholders. In general, enforcement of existing regulation might be at least as important as introducing new regulation. Binding disclosure standards should be extended to a much broader range of issues, in particular when it comes to managerial compensation. In fact, the most urgent governance reform at the European level at the moment may be to increase

transparency. The combination of deliberate concealment of relevant information and generally opaque corporate governance environments presents a serious obstacle to cross-border control transactions in many countries in Europe.

The rules that regulate the takeover process and ensure that shareholders have the right to vote on takeover defences once a bid has been made are now largely accepted by most countries, even by Germany. Many of the other rules in the draft directive and the Winter proposals are also uncontroversial. Whether these rules are part of a binding proposal or not seems secondary since they would presumably be part of any recommendation and adopted by member states. The provision in the draft directive (Article 11) that renders restrictions on voting rights and on the transferability of shares unenforceable against bidders should probably be part of a binding directive. Regulatory competition from the US suggests that management or controlling owners may otherwise seek jurisdictions that allow takeover defences such as voting caps.

Our analysis has been critical of the strict mandatory bid rule ruling out any control premium. However, even though the mandatory bid rule reduces control transfers, it does in one important way improve investor protection: the mandatory bid rule prevents control transfers in which the gains for incumbent and new controlling (minority) shareholders do not stem from value creation but are redistribution at the expense of small shareholders. Some form of a mandatory bid rule with a reasonably high threshold for triggering and an allowance for some control premium, that is, a less strict rule than that advocated by the Winter Group, could also be part of a recommendation, perhaps even of a binding part to a directive (in practice most member states already have such a rule). For instance, the rule could put an upper limit on the differential between the price paid in the block transaction and the price offered in the subsequent mandatory bid.

More generally, there are strong arguments against wholesale changes of corporate governance systems. The strong interrelationship between the different mechanisms suggests great caution in radical reforms. The combined effect of the mandatory bid rule and the break-through rule, as shown in Section 6, would drastically have reduced the incentives to hold controlling blocks and effectively eliminated controlling shareholders from many companies. Alternatively, the proposal would have triggered new hard to foresee control structures through pyramiding and less transparent arrangements.

7.3. Policy recommendations and the role of transparency

In our view, the objective of regulation should not be to intervene in specific control structures or generally discourage controlling blocks. Indeed, we are against discouraging the delegation of control and monitoring to individual large shareholders. Rather, we favour an approach that attempts to improve the general corporate governance environment, in particular by greatly increasing transparency through

stricter enforcement of existing regulation and an extension of these measures to more areas. Controlling shareholders do in most cases perform some positive function in constraining managerial behaviour and they may be critical to some forms of restructuring (sometimes while appropriating considerable private benefits). The broader objective of regulation should be to make monitoring by large shareholders superfluous, not to get rid of them.

In its quest to increase contestability and corporate governance the Commission should rely less one-sidedly on hostile takeovers and proxy fights. The level of contestability in a particular system stems from the combined effects of all the corporate governance mechanisms. Rather than undermining controlling shareholders, and effectively weakening this critically important mechanism of corporate governance, the Commission should try to exploit the other mechanisms. These mechanisms can constrain controlling shareholders and managers and thus also improve the functioning of the market for corporate control. It is encouraging that the second report from the Winter Group, after its mandate had been extended, is on corporate law reform in the EU. Many of the proposals in that report are about strengthening these other mechanisms, in particular the recommendations addressing transparency.

We are convinced that improving transparency is key to activating the other mechanisms, especially minority shareholders and media. More information on what controlling owners and managers do, and how they are compensated would help curb some of the excesses and put pressure on them to perform. We also believe that making managers, controlling owners and board members more accountable through various measures such as standardized fiduciary duties can help. But we are less optimistic that creditors can play a larger role in corporate governance than they already do. Banks are neither capable of nor interested, it seems, in monitoring management on a daily basis.

The bottom line is that no single mechanism is likely to deliver sufficient corporate governance and restructuring. Large institutional investors with a tradition of portfolio-orientation have been drawn into governance in the US. In the UK they have remained more passive. On the European Continent some of these institutions are new, but other institutional investors have been deeply involved in corporate governance. The evidence on their impact is still weak, but more can be done to entice these institutions to play a more important role. Litigation is another area where European experience is limited. In the US the exercise of this mechanism has largely benefited lawyers (Romano, 1991), but it could probably be strengthened in Europe where the risk for abuse appears to be less pronounced due to differences in legal practices. Perhaps some progress could also be made on the independence of directors on boards forcing controlling owners to accept minority shareholder representatives. Independence of auditors is also desirable.

To conclude, any regulatory exercise, in particular at the EU level, must take into account that a corporate governance system is highly complex and made up of many complementary parts. An intervention in part of the system may have ripple effects

that are not immediately obvious and hard to fully anticipate. The different parts of the system fit together and changes in one part may undermine the functioning of another, but changes in one mechanism could also reinforce another mechanism. Consequently, the impact of an individual takeover rule need not be uniform but depends on the context. As we have shown, this applies, for example, to the mandatory bid. The strict mandatory bid rule included in the draft takeover directive goes against both objectives set up by the Commission: improved contestability and a 'level playing field'. The rule lowers contestability in firms with controlling shareholders, and since it has a differential impact depending on the structure of ownership and control, the rule makes the playing field less levelled.

Discussion

Tito Boeri
Università Bocconi

This paper provides an in-depth assessment of the most recent attempt by the Commission to introduce a pan-European take-over directive. In particular, it evaluates the inner coherence of the two reports issued by the so-called Winter Group in 2002 and challenges the key recommendation of this Group to adopt a new breakthrough rule, ruling out the veto right of blockholders with less than 25% of equity capital.

As I am not an expert of this field, I am not in a conflict of interests when I draw the conclusion from the paper that the Commission headed by Jaap Winter would have gained much from having some economists on board. Berglöf and Burkart identify a major inconsistency in the reports issued by the Winter Group: the breakthrough rule undoes the effects of the mandatory bid rule, which is also prescribed by the report. The tradeoff between protection of minority shareholders and encouragement of takeovers would also seem to have been neglected by the Winter Group, according to the two authors.

Berglöf and Burkart cover much ground in highlighting the drawbacks of the loss of the control premium of blocks owning less than 25% of the equity capital and, more broadly, the stronger contestability of minority control envisaged by the Winter Group. An additional implication of the breakthrough rule in many European countries, where family ownership is predominant, is a reduction of the liquidity of stock markets. As family owners are rarely liquidity constrained, the most likely response to the breakthrough rule is indeed an increase in the stakes of the controlling shareholders which could further reduce the liquidity of European stock markets.

There is a more fundamental issue, regrettably addressed only in the final part of the paper by Berglöf and Burkart. It concerns the desirability itself of having a pan-European regulation on takeovers replacing country-level legislations. This issue is far

from trivial, in light of the large differences in corporate structures and takeover regulations still characterizing the European landscape, which are vividly characterized in the paper. Pan-European regulation may enforce the Single Market principles, reducing obstacles to cross-border mergers and acquisitions. But since large cross-state differences in regulations persist in the US, and some convergence in regulations (to the UK model) is occurring in any event in Europe, would not competition among systems suffice to ensure appropriate capital market integration?

Julian Franks
London Business School

The paper by Berglöf and Burkart examines the European Commission's proposals for European Takeover Regulation based upon the Winter Committee's Report. The authors provide an economic analysis of the two most important proposed rules, 'the mandatory bid rule' and 'the break-through rule' and how they interact with existing ownership structures in Continental Europe. This economic analysis is largely missing from the Commission and Winter proposals.

The Commission's views are guided by some important principles: European industry needs restructuring, takeover markets can play an important role in restructuring, and European takeover markets are constrained by restrictive shareholder ownership structures. To accelerate European restructuring, companies must be better exposed to an efficient auction market that is the key feature of a market for corporate control.

Violation of freedom of contracting

The proposed changes analysed by the authors are aimed at changing Continental European capital markets, which are regarded by the Commission as being less developed than their Anglo American counterparts. The main obstacle to that development is the concentrated ownership structures of public companies. The authors argue that such ownership structures give rise to large private benefits of control and disincentives to engage in company auctions especially when performance is poor. The result is much lower intensity of corporate restructuring, and less adaptation to changing industry conditions.

We should begin any critique of the Commission's proposals by understanding that changes envisaged by the Winter Report, especially the two rules analysed by the authors, restrict freedom to contract and are likely to have important implications for *ex ante* efficiency. In pursuing their approach to regulation, the Commission has chosen to follow UK rather than US practice. Whereas Federal law has imposed fewer restrictions and largely left regulation to individual states (and thus allowing competition between the states) the UK has taken a very prescriptive and detailed approach to takeover regulation, violating freedom of contracting.

In the UK regulation and institutional investors effectively prevent owners of companies from adopting discriminatory ownership structures and takeover defences

when they list on the London Stock Exchange. As a result, there are only a handful of companies on the London Stock Exchange with discriminatory ownership structures – for example, two tier share structures – and these pre-date the rules. For example, takeover rules include a mandatory bid when one company owns 30% of another company's shares; at 15% a company must state its intention if it intends to bid in the subsequent 12 months; and a stake greater than 3% must be disclosed.

In contrast, in the US there are far fewer regulatory constraints resulting in a much greater variety of ownership structures. For example, Field and Karpoff (2002) find that in a sample of 1019 IPOs takeover defences were enshrined in many companies' articles of association: in 29% a supra majority was required to approve a merger or replace directors; and in 14% there were other anti-takeover provisions. Also, in 58% of the IPOs the company was incorporated in Delaware where there are anti-takeover statutes. Presumably the price of the shares at the IPO stage reflects these ownership restrictions.[22] Nor is there a mandatory bid rule, and the disclosure threshold for outside ownership is 5%.

Do hostile takeovers add value?

The authors suggest that 'even in countries with strong institutions, dispersed ownership and hostile takeovers are relatively rare'. However, my own reading of the evidence is different. Although the evidence of Holmström and Kaplan (2001), cited by the authors, suggests fewer contested bids in the 1980s compared with the 1990s, hostile takeovers remain at about 15% of total takeovers. Moreover, these numbers probably understate the importance of hostile takeovers. The old dictum that the 'threat of a good hanging concentrates the mind' seems appropriate here. Other evidence suggests that the benefits of restructuring in hostile takeovers are substantially greater than in agreed bids.

Bhide (1989) examines a large number of case studies of both hostile and friendly acquisitions. He finds hostility is associated with large restructuring benefits. In friendly transactions the music rarely stops and the merged boards usually find enough 'seats for the boys' with the result that restructuring is delayed and the benefits reduced. Franks and Mayer (1996) provide other evidence that bid premiums to target shareholders in contested takeovers are much larger than in agreed transactions. They suggest it is more likely that these larger premiums are associated with higher merger benefits.[23]

[22] Bebchuk and Hart (2002) point out that it will be difficult to limit the proposals to takeovers. For example, the breakthrough rule will allow the dismantling of discriminatory ownership structures even in the absence of a takeover motivated by a restructuring. Thus, these rules would spell the end of pyramids, dual class structures etc.

[23] Shleifer and Summers (1988) take a very different view and argue that the larger benefits in hostile takeovers is simply a redistribution of wealth from one stakeholder to another.

Concentrated ownership and private benefits of control

The authors' main criticism of Continental type capital markets is their concentrated ownership structures which give rise to substantial private benefits of control. The Winter Report's proposals suggest that by dismantling these ownership structures, companies in European capital markets will be exposed to the competition of the takeover market. The authors cite the international evidence of Dyck and Zingales (2001) who find that private benefits are much larger in countries with concentrated ownership and less well developed capital markets. However, there is substantial variability of private benefits across the Dyck and Zingales (2001) sample. In Germany private benefits are estimated at 10%, Italy 37%, and Canada as low as 1.3%, which is similar to the UK at 1.6%.

Why should Canada with a very concentrated and pyramidal ownership structure have similar private benefits to the UK? One reason might be that in Canada they have adopted minority protection provisions that limit private benefits. Thus, whereas the UK discourages private benefits through regulating ownership structures, Canada simply has minority protection rules. In other words, one country's regulation severely disrupts *ex ante* contracts through limiting ownership structures whereas the other country provides *ex post* protection.

Conclusion

The authors do a very good job of appraising the *ex post* costs and benefits of proposals which, however, may have significant *ex ante* effects on efficiency. Moreover, I have the impression that the Anglo American capital markets are viewed by the authors and the Commission as being homogeneous, from a regulatory point of view, when in fact they are very different. Since both the US and the UK have flourishing stock markets it is not clear which approach is superior. Further consideration of these issues would provide more critical analysis of the Commission's proposals.

Panel discussion

In replying to Julian Franks, Erik Berglöf discussed differences between the US and UK, in particular regarding the role of enabling and mandatory rules, and agreed that Canada is an interesting example of how transparency can be achieved.

Paul Seabright emphasized that legal changes induce endogenous responses, and changes in takeover rules may not do much harm even when they are not beneficial. George de Ménil thought contestability is unambiguously beneficial, because control rents are not necessary for good governance. Giuseppe Nicoletti asked what the aim of the EU initiative would be. He wondered whether it could be justified on the basis

of transaction costs so that harmonization of takeover rules is beneficial. Erik Berglöf answered that the EU initiative focuses on horizontal industrial policy and the role of managers or controlling owners.

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