Takeovers and the European Legal Framework

A British Perspective

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ROUTLEDGE
Cavendish

3 EC regulatory objective I – shareholders

3.1 Introduction

Apart from the fears of a litigation culture arising from the introduction of a statutory regulation of takeovers, discussed above in Chapter 2, the implementation of the Directive has posed questions in relation to the protection of the interests of shareholders following a takeover bid. This chapter analyses the extent to which the Directive protects the interests of the shareholders on the one hand, and the facilitation of cross-border takeover activities on the other. With regard to shareholders, particular attention is given to the interests of minority shareholders who may be squeezed out by the controlling majority who take over the company. This chapter also looks at whether the Directive adds anything that the Code would not provide were the Directive not to be implemented. The argument advanced here is that the Directive generally provides for shareholder protection, which is already enshrined in the UK measures, the Code, whilst failing in the facilitation of cross-border takeover activities. To that extent, this chapter argues that the Directive adds nothing of value to takeover regulations in the UK in this context. The chapter also looks at the possible conflict between protecting shareholders in a target company on the one hand, and facilitating investment through unrestricted takeover activities for a competitive European economy on the other.

The regulatory objectives here include ensuring that shareholders have adequate information, and protecting shareholders from being pressured by managers into making decisions on a takeover bid. In achieving these objectives, Arts 3 and 9 of the Directive are applicable. The Directive requires that managers provide full information to shareholders concerning the bid. Managers should refrain from denying shareholders the opportunity to decide the merits of a bid. If managers wish to resist any bid, they should obtain approval of the shareholders to do so, otherwise managers should refrain from taking action that would frustrate the bid. These requirements are not novel to the UK, as they have always been applied under the Code. For example, r 19 of the Code requires that information concerning the bid be given to shareholders, and r 21 requires managers to refrain from frustrating a bid. Thus, the Directive's requirements reaffirm UK takeover rules under the Code, which have now been specifically implemented by s 943 of the CA 2006. However, for takeover regulation at Community level it is preferable to act in the interest of all stakeholders including investors (or rather predators). This could possibly create a conflict of objectives.

It should be remembered that shareholder protection is not the only objective of the takeover regulation at Community level. There is also the objective of facilitating cross-border investment in takeover activities by removing barriers to takeovers. These two objectives emanate from the Winter Report.[1] It would appear that the emphasis on shareholder protection could be in conflict with the facilitation of cross-border takeover activities. Article 9 seeks to remove defensive tactics barriers, vesting decision power in shareholders, in order to protect their interests. If it is in the interest of shareholders to authorise defensive measures to frustrate a takeover bid under Art 9 of the Directive, that could be seen as contrary to the objective of facilitating takeover activities; it is needless to mention that a takeover would not succeed if opposed by shareholders. Of course, if the shareholders specifically refuse a takeover, their informed decision ought to be respected.

The problem is that the application of Art 9 is optional under Art 12 of the Directive. This is not a problem in regard to protecting shareholders within the UK with an exclusively UK takeover bid. It is likely to be a problem if a UK bidder would attempt to take over an offeree in another Member State that does not apply Art 9; the management of the offeree may defeat the takeover by defensive measures without shareholder approval and contrary to the interests of shareholders. In that sense, the Directive, by making Art 9 optional, fails to facilitate takeover activities.

There is also a problem with other barriers, such as restriction on voting, which might affect control of the successful bidder and in turn defeat cross-border takeovers. To make good this barrier, the Directive provided for what is commonly known as the breakthrough provision under Art 11. Once a bidder has obtained a certain stake in the target company, by virtue of Art 11, the bidder is allowed to break though any restrictions imposed by the shareholders or by the company – this is designed to facilitate cross-border takeover activities. But this breakthrough provision only applies to barriers after the bidder has acquired a controlling stake in the target company; defensive measures authorised to defeat initial bidding would remain in conflict with the facilitation of takeover activities. However, and despite the recommendations of the Winter Report, Art 12 of the Directive makes both Arts 9 and 11 optional.

Facilitation of investment through takeover activities is important, as is shareholder protection, for a competitive European economy. Both

1 European Commission, 'Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids' (Brussels, 2002) – referred to hereinafter as the Winter Report.

Arts 9 and 11 of the Directive were meant to serve these dual conflicting objectives of takeover regulation. Political interests seem to have led to a compromise that optimised these objectives. As such, shareholder protection remains in conflict with the need to facilitate investment through unrestricted takeover activities. Rather than question the commitment of European legislators to facilitating takeover activities, one has to appreciate the reality of a political role in the Community legislative process; a political compromise had to be struck. However, sight should not be lost of the general strengthening of takeover regulation in Europe brought about by other provisions of the Directive, much of which is undoubtedly a step forward in many Member States.

3.2 Principle of shareholder decision-making

3.2.1 Inadequate common law decision-making power to shareholders

Until recently, company law provided inadequate decision-making powers to minority shareholders to protect their interests. Whereas shareholders are the residual owners of a company as a legal entity, the control of company affairs is generally vested in the management, the directors. Unless the articles of the company do not provide power to the directors, the shareholders cannot exercise the residual power to act on behalf of the company. Even then, decision-making powers are vested in the majority shareholders in a general meeting. Where the articles give power to the directors to issue new shares, the directors are likely to use this power to issue new shares in order to defeat a takeover bid or to promote their own interests.[2] The effect of such action may well be contrary to the interests of shareholders who would have preferred a different outcome from the takeover bid.

The inadequacy of common law in providing power of decision-making to minority shareholders stems from the legal treatment of the relationship between directors and shareholders in regard to the legal entity, the company. In general terms, a company is a legal entity separate from its shareholders. The directors are agents of the company and not agents of the shareholders, and directors primarily act in furtherance of the interests of the company as a legal entity and not per se in the interests of shareholders. This stems partly from the rule in *Percival v Wright*[3] which states that directors' duties are owed to the company and not to shareholders. Where the directors are in breach of their duty to the company, the rule in *Foss v Harbottle*[4] precludes a minority shareholder from disciplining such directors. At common law, unless

2 An example of such misuse of directors' power was attempted in *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, where directors had issued shares in order to influence the outcome of a takeover in their favour.

3 [1902] 2 Ch 421.

4 (1843) 2 Hare 461.

the shareholder can complain through the exceptions in the rule in *Foss v Harbottle*, a minority shareholder remains inadequately protected and has little influence on decision-making that affects the outcome of a takeover bid.

One situation illustrating the inadequacy of decision-making powers to minority shareholders at common law can be found in the case of *Hogg v Cramphorn Ltd*.[5] Directors in this case were approached by a prospective bidder for all the issued shares in the company. If the bidder was successful, the directors feared that the bidder would have effective control of the company due to the voting power such shares would provide. To prevent the bidder succeeding, the directors used their powers in the articles to allot unissued shares in the company to a trustee. This allotment was aimed at defeating the takeover bid. Shareholders were not contacted, and it was clear that this action was not in their best interests. The shares were issued for a collateral purpose, not in the interests of all the shareholders. A minority shareholder, who was interested in the success of the takeover bid, sought the assistance of the court. The court referred the matter to the shareholders' general meeting by which an ordinary resolution was passed to accept the allotment of the new shares. An opportunity for the minority shareholders to make a decision on the bid was effectively prevented.

This inadequacy of decision-making powers to minority shareholders is further illustrated in another case, *Bamford v Bamford*,[6] where directors similarly issued shares for a collateral purpose other than bona fide for the interests of all shareholders. The opportunity to make the decision was equally denied to shareholders. In this case, after allotting new shares aimed at defeating a takeover bid, the directors caused an ordinary resolution to be passed to affirm their action. Again, the minority shareholders complained without success.

3.2.2 Statutory protection of shareholders' interests

Company law statutes, in the past, have also been inadequate to remedy the plight of minority shareholders. Section 172(1) of the CA 2006 does not resolve this but simply endorses the common law position. This requires directors 'to promote the success of the company for the benefit of its members as a whole', but adds that in so doing the director is to 'act in the way he considers, in good faith, would be most likely' to fulfil the duty. Unless the duty owed to the company was to be construed 'as a duty to promote the success of the business venture in order to benefit the members',[7] company law has always given inadequate protection to minority shareholders. Where shareholders are faced with a takeover bid, adequate protection was only

5 [1967] Ch 254.
6 [1970] Ch 212.
7 J Parkinson, *Corporate Power and Responsibility* (Clarendon Press, Oxford 1993) 77.

found in the provisions of the Code. Principle 3 and r 21 of the Code preclude the target directors from taking any action (unless authorised by the shareholders) that would defeat or frustrate a takeover bid. The Directive requires the same standard under its Art 9, which is implemented by the CA 2006.

Thus, the law on takeovers, by way of regulations, starting with the provisions in the Code and now the CA 2006 that implements the Directive, provides a wider protection to interests of all shareholders faced with a takeover bid. By making Art 9 optional, the Directive lacks in providing decision-making power to shareholders. Instead, the Directive protects all shareholders by requiring that they receive timely and adequate information concerning the bid, and particularly protects minority shareholders' interests, albeit only to the extent that they obtain a fair price for their shares on exiting the company.[8]

3.2.3 Shift of decision-making power to shareholders

For all its rhetoric about respecting national contexts and ensuring transparency, the Directive sought to impose a rule granting shareholders the sole right to decide on the outcome of takeovers. While uncontroversial to British eyes accustomed to the Code, the Directive would have had the effect of changing the centre of gravity of more managerialist and stakeholder-orientated systems of corporate governance, but for the compromises that reduced some provisions into optional ones.[9] The cornerstone of shareholder protection is Art 9 of the Directive, which prohibits management from taking decisions that would frustrate the bid but leaves the decision-making on the bid to shareholders. However, this provision is made optional, such that Member States are free to allow management to make the ultimate decision even to prevent a bid. Apart from Art 9, it is a question of how far other provisions in the Directive provide for shareholder supremacy in making decisions on takeover bids.

The general approach taken under the Code has been to protect shareholders by giving them all the powers to decide on takeover bids. It is not for the directors to decide on a bid. Directors have a duty to pass on information to shareholders concerning the bid, and to advise shareholders. Although until 20 May 2006 the Code had no legal force, it kept at bay the directors using defensive measures to defeat a takeover bid. As Davies has put it, 'the directors of the target are thrown back on their powers of persuasion' and

8 See further the discussion below on 'squeeze-out right' which in effect denies investment rights to minority shareholders.
9 A Johnston, 'The European Takeover Directive: ruined by protectionism or respecting diversity' (2004) 25 Co Law 270.

'the final decision on the success of these defensive moves rests with others'.[10] With this sting from the Code, the directors' option in defeating a takeover bid lay in the economics of management. Pettet summed up these economics very well:

> . . . it is the orthodox view that the most effective method of preventing a bid is a well-run company with a high share price. The economics of this make it relatively difficult for the bidder to come up with a higher offer price, or to want to. The corollary of this is the painful fact that if the share price is low and the company appears not to be well run, then there may well not be a great deal which can be done.'[11]

There is an argument that managerial decision-making supremacy in the face of a takeover bid has the merit of securing a better deal for shareholders. For instance, if the management decided to resist a particular takeover bid, this might result in the offeror revising the offer and in turn creating a higher share premium for shareholders.[12] This argument imports as its rationale a solution to a situation where an offer is being resisted for being low. However, often it is not for low share price that the management seek to resist bids, but due to a whole range of reasons including mere fear that management will lose control and their jobs. At any rate, shareholders are capable of deciding on the adequacy of the price offered, and the market price can be used as an index for shareholders to decide. It is also argued that any uncoerced decision against acceptance of a bid can only be made at the board of directors' level.[13] Implicit in this argument is a suggestion that shareholders are incompetent to make decisions favourable to their own interests. Followed to its conclusion, the power of decision-making would shift from shareholders to directors, or rather remain with directors.

Arguably, subject to appropriate safeguards, boards should be able to take defensive measures when the organisation they should know better than anyone else is threatened by potential break-up and asset-stripping through hostile takeovers.[14] However, that argument ignores the danger of relying on director primacy to ensure shareholder protection. Once a takeover bid is imminent or made, managers' attitude is naturally bound to change. 'Often their own performance and plans are brought into question and their own jobs are in jeopardy. Their interest is in saving their jobs and reputation

10 P Davies, *Gower's Principles of Modern Company Law* (6th edn, Sweet & Maxwell, London 1997) 784.
11 B Pettet, *Company Law* (Longman, Harlow 2001) 423.
12 D Henry, 'Directors' recommendations in takeovers: an agency and governance analysis' (2005) 32 *Journal of Business Finance & Accounting*, 129–59.
13 M Lipton, 'Takeover bids in the target's boardroom' (1979) 35 Bus Law 101, 114.
14 J Dean, 'Directors' duties in response to hostile takeover bids' (2003) 14 ICCLR 370, 377.

instead of maximising the value of the company for shareholders.'[15] Moreover, in UK company law it is extremely difficult to find that directors have not acted for the interest of the company. With all the difficulties of aggrieved minority shareholders litigating against directors, the answer lies in promoting shareholder supremacy. If the directors reasonably believe it to be for the good of the company and its future business to resist a takeover, then they should convince the shareholders of that and only take action against unwanted bids through the consent of the shareholders.

3.2.4 Pre-bid versus post-bid shareholder decisions

Company law generally gives the power of decision-making to shareholders by means of a vote in the general meeting. The Directive takes the same approach when it requires that directors should seek shareholders' approval in a general meeting before adopting measures or actions that may frustrate a takeover bid. The need to defer decision-making on the merits of a takeover bid to shareholders was also supported by the Winter Report. This is referred to as the shareholders decision-making principle. To the Winter Report, Art 9 of the Directive ensures that shareholders can decide on whether or not to tender in a bid, and that any action to frustrate the bid requires the specific authorisation of the general meeting of shareholders at that time.

Thus, in applying the shareholders' decision-making principle, the Winter Report recommended that shareholders' decisions taken prior to a bid (a pre-bid decision), even in a general meeting, should not be used by directors to frustrate a bid. Only when a bid is actually announced, and the shareholders can really assess relevant information, can they in fairness be asked to decide whether this takeover bid should be frustrated by the board or not.[16] Further, the Winter Report suggested that the board should not take steps to favour a bid that in any way pre-empts the right of shareholders to reject it – in other words, shareholders must have the final word on the outcome of a takeover bid.[17] The Directive adopts the spirit of the Winter Report on the question of pre-bid versus post-bid decisions.[18] This has the effect of limiting when shareholders may make their choice to the period during the bid and not

15 Winter Report, 2002, 21.
16 Winter Report, 2002, Recommendation 1.2.
17 Winter Report, 2002, 27.
18 Art 9(2) of the Directive partly provides that 'such authorisation shall be mandatory at least from the time the board of the offeree company receives the information referred to in the first sentence of Art 6(1) concerning the bid and until the result of the bid is made public or the bid lapses. Member States may require that such authorisation be obtained at an earlier stage, for example as soon as the board of the offeree company becomes aware that the bid is imminent.' The example given suggests that interpretation of Art 9(2) would prevent directors from relying on a resolution made years ago by shareholders authorising defensive measures.

before. The rationale seems to be that shareholders can only fairly decide on the merits of a takeover bid once they are actually faced with one. This has the effect of suggesting that shareholders cannot calculate the risk of their decision in the pre-bid period or that they are not capable of doing so, and hence they should only decide in a post-bid period. Ferrell rightly observed that:

> . . . if shareholders are too confused or disinterested to make this calculation, then why assume that shareholders are sufficiently competent to make decisions on defensive tactics in the post-bid period? Surely an across-the-board assumption of shareholder incompetence in the pre-bid period is too sweeping.[19]

Although the rationale of the Winter Report is a common-sense approach to protecting the right of shareholders to make decisions, it appears to adopt an approach which is too paternalistic. It also curtails freedom of contracts that shareholders may wish to make. It also renders agency obsolete in respect of the shareholders–management relationship. Legally, there is no justification, it is argued here, for rendering ineffective an authorisation given prior to a bid by shareholders in a general meeting for directors to frustrate a takeover bid. Shareholders are free to make decisions that are potentially detrimental to them, that is that allow management to frustrate a bid even if *ex post* shareholders will find it in their interest that management cannot interfere with the acceptance of the bid.[20]

On a contractual basis, if parties to a contract were to wait on making decisions until they had the full facts and information of the market, few contracts would be made. If such few contracts were prevented on the basis of parties not having full information, such approach would potentially curtail freedom of contracts. If shareholders by their election chose to have directors act as their agents to frustrate future bids, wholly or on a specified basis, just because shareholders do not assess a particular bid at the time it is made, does not mean that they should be regarded as having failed to exercise their right of decision-making in regard to a bid in question – it only means that they took the decision in advance, and should not be paternalistically protected from the risk that they took voluntarily unless it could be established that they were grossly misled.

Moreover, shareholders' decision-making in a pre-bid period could be left open-ended, entitling shareholders to review and alter their own prior decision that may have authorised a defensive approach and to decide to

19 A Ferrell, 'Why Continental European takeover law matters' in G Ferrarini and others (eds), *Reforming Company and Takeover Law in Europe* (OUP, Oxford 2004) 561, 573.

20 PO Mulbert, 'Make it or break it: the break-through rule as a break-through for the European takeover Directive?' in G Ferrarini and others (eds), *Reforming Company and Takeover Law in Europe* (OUP, Oxford 2004) 711, 724–5.

accept an offer. Possibly for the purpose of avoiding legal proceedings in determining on what basis shareholders took a decision, and avoiding a situation where minority shareholders may demand to review a pre-bid decision, it is much fairer to take a paternalistic approach and defer decision-making to the post-bid period.

3.2.5 Shareholder value versus corporate autonomy

The Directive exposes the tension between promotion of 'shareholder value' and the promotion of 'corporate autonomy' as far as takeovers are concerned. Johnston[21] observes that the compromise in the Directive as to Art 9 comes as a disappointment to those who wanted to see provisions analogous to the Code rolled out across the EU. Johnston explains that advocates of the approach taken under the Code would argue that the Directive fails to create the market for corporate control that would expose entrenched management to the discipline of the hostile takeover, and is therefore fundamentally flawed. Johnson further explains that those opposed to corporations being governed purely with a view to generating shareholder value may consider the compromise a victory for managerialism and corporate autonomy, with potentially beneficial effects for other stakeholders. For them, Johnston explains, the compromise will demonstrate that there is no Europe-wide consensus that shareholder value should be the sole goal of publicly traded corporations, and could even be seen as a qualified rejection of the idea that a market for corporate control always leads to optimal resource allocation.

Shareholder value is commensurate with the wider EC aims of free market and free movement of capital. If power to decide the transfer of shares in the company or the outcome of a takeover bid is left in the hands of directors, who are often sophisticated professionals keen to promote the interest of the company but only if that does not endanger their existence and interest, takeovers could hardly achieve the wider EC aims. Notwithstanding the benefit of delegating power in governance, unless power ultimately belongs to the people in any organisation, whether it is an economic or political organisation, the interests such power is supposed to protect are prone to being trampled by the holders of such power if the same are not the end beneficiaries. It is possible that the high level of concentrated share ownership in continental Europe is the reason why the compromising of Art 9 is found acceptable. In companies with concentrated share ownership, corporate autonomy is more likely to be accepted, for with the majority or block shareholding also comes management control, and the rules on prior authorisation under Art 9 and the concept of shareholder value become less important and remain only a matter for the minority shareholders to worry about.

21 A Johnston, 'The European Takeover Directive: ruined by protectionism or respecting diversity' (2004) 25 Co Law 270.

3.2.6 *Community versus national interests*

The regulatory analysis of takeovers cannot be complete without considering the tension between the interests of the Community at European level on the one hand, and the interests of individual Member States at the national level on the other. National interests may lie in staying the course on sector self-regulation to protect local markets, whilst Community interests may lie in harmonisation of regulation of the market at large. The cherished values of flexibility in self-regulation may mean that the Panel is able to change the rules as and when it suits it to do so. Whilst such rules may reflect national business expectations, such freely changing rules would be difficult to harmonise at Community level. The spirit of national interests taking priority over Community interests has, unfortunately, historically marred the process of and led to the compromises that ushered in the Directive. Provisions like Art 9 on defensive measures and Art 11 (the breakthrough rule) reflect the spirit of Community interests but for having been rendered ineffective by the nationalist interests that reduced them to optional provisions.

Optional provisions apart, even in what is left of the provisions in the Directive, it is easy to overlook at first glance that these are implemented in a manner that gives priority to national interests at the expense of Community interest. Take, for instance, if a Member State, as it is free to do so, sets a higher threshold for a mandatory bid, whilst another sets a low threshold. The likely outcome is that takeovers would be hard to occur in a Member State that has a higher threshold. A higher threshold would mean that it takes a little more acquisition of shares and possibly longer to trigger a mandatory bid rule. Yet if that were the result of implementing the Directive, Community interests in achieving free movement of capital would be defeated, even when a mandatory bid provision is not optional. Once a piece of legislation is allowed to be moulded by much political agenda, as seems to have happened with the Directive, it is bound to produce political rules. Such rules, unlike legal rules, require constant appeasement of the political participants, an art the Community may not be competent to provide. The results are likely to be a piece of legislation that achieves only the form, and not the substance, of regulating takeovers as intended. Ultimately then, shareholders at Community level are not adequately protected, as the diversity of rules and their application gives no uniformity.

3.2.7 *Ultimate decision-making vested in shareholders*

By recital 3 of the Directive, the Directive aims at creating Community-wide clarity and transparency in respect of legal issues to be settled in the event of takeover bids. This aim is taken a step further by Art 9, which facilitates transparency by vesting the power of decision-making in the shareholders. As directors are traditionally answerable to the company and not to shareholders, their decisions during a takeover bid could be questionable as to

whether they are in the interest of shareholders. As such, ensuring protection of the interests of shareholders, Art 9 precludes directors from taking any action or decision which would otherwise frustrate a bid. This is a principle of proper purpose decision, which is checked and supervised by shareholders to whom the ultimate benefit of a takeover lies. The same principle exists in company law, requiring directors to act for a proper purpose in the interest of the company as a whole.[22] Article 9 simply applies this principle in a practical context.[23]

However, it is difficult to see how shareholders, who are likely to focus on short-term profit exhibited in the offer price, can make a better decision than professional directors of the target company. The bidder negotiates through professional agents, while the target does so directly as shareholders, often with little professional skill of negotiation. That would create an imbalance of bargaining power. The resultant effect of a strict interpretation of Art 9 is to deprive target shareholders of a vital service of professional directors in negotiating for a better deal. It is not necessarily that a higher price offer is a better deal for shareholders. It may well be that an offer should be rejected after the informed opinion of the directors for long-term gains. If directors are rendered passive by a strict application of Art 9, then the unfortunate result is likely to be a short-term profit at the expense of the long-term interests of the company as whole, including the interests of other stakeholders.

However, whereas directors will have the expertise in share value and company prospects, faced with the possibility of being ousted out by the new controllers if the bid were to be in favour of shareholders' interests, directors may not make the right decision. Whether this can be resolved by agency principles requiring that directors, as agents, work in the best interest of the shareholders, as principals, is difficult to assess. Rather than take risks, it is no wonder that Art 9 sensibly cuts through all these by vesting decision-making power in the hands of shareholders. The risk of directors making decisions solely to protect their positions far outweighs the risk of shareholders being deprived of a professional service in deciding what is in the best interests of the shareholders and the company as a whole.

Further, a strict application of Art 9, equivalent to the long-standing provision of the Code,[24] creates transparency and thereby creates market confidence. As residual beneficiaries of the company assets, combined with

22 *Hogg v Cramphorn* [1967] Ch 254; *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821.

23 Note, however, Art 9 is broader than the proper purpose principle, which is only part of the analysis in Art 9.

24 Rule 21(1) of the City Code provides: 'During the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent, the board must not, without the approval of the shareholders in general meeting:– (a) take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits . . .'.

the common law requirement that decisions be take for a proper purpose,[25] it is sensible to vest decision-making ultimately with shareholders themselves. However, for the purpose of facilitating cross-border takeovers, the compromise of Art 9 of the Directive is a watering-down of the centrepiece r 21 of the Code.[26] This central feature of the Code has always had the effect of limiting defensive tactics such that management would not appeal to shareholder loyalty or patriotism or use their own resources to buy target company shares in the market.[27] Instead of extending this central principle to takeover regulations in Europe to facilitate cross-border takeovers, the Directive waters it down by making it optional. Thus, shareholder autonomy in decision-making and the ability to limit management's defensive tactics cannot be applied with certainty in cross-border takeovers.

3.3 Proportionality between risk-bearing capital and control

The principle of proportionality between risk-bearing capital and control is one of the two guiding principles relied upon by the Winter Report in recommending measures for inclusion in the Directive, including Art 11 or the so-called breakthrough rule. According to the Winter Report,[28] the extent to which a shareholder holds risk-bearing capital should determine the extent to which he is able to determine the affairs of the company and the operation of its business, and furthermore that the holder of the majority of risk-bearing capital should be able to exercise control. Thus, a successful bidder who has acquired a substantial part of the risk-bearing capital in a general bid for all the shares of the company should have the ability to break through any mechanisms that frustrate the exercise of proportionate control.[29] It is unclear why the Winter Report viewed the breakthrough rule as compatible with the proportionality principle – when the effect of the former is to disable the latter. One matter seems clear – the breakthrough rule is novel to the UK's company law approach of breaking through entrenched rights, and it may accord less protection to shareholders.

The Winter Report's breakthrough recommendations are adopted in

25 In *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, directors issued shares to a bidder for an improper purpose, that is, not per se in the interest of the company or shareholders but to influence the outcome of a takeover in the interest of directors – the court set aside the issuing of these shares.

26 Since its inception in 1968, the central feature of the Code has always been its prohibition of defensive actions by management without authorisation of shareholders. The rule first contained in General Principle 7 of the Code in the 1968 version prohibited management from taking any action that would frustrate a bid, in the event of an offer or imminent offer, without prior authorisation of shareholders.

27 P Davies, 'The regulation of defensive tactics in the United Kingdom and the United States' in K Hopt and E Wymeersh, *European Takeovers* (Butterworths, London 1992) 200.

28 Winter Report (2002) 21.

29 Winter Report (2002) 29.

Art 11 of the Directive. At the core of Art 11 are two meanings of the breakthrough rule. First, when shareholders exercise their power of decision-making under Art 9, restrictions on voting rights provided for in the articles of association of the offeree company shall not have effect at the general meeting. This means that, in seeking to authorise or otherwise restrict defensive measures in accordance with Art 9, regardless of any contractual or other restrictions on voting rights or whether some shares carry multiple-voting rights, all shareholders are to exercise one vote per share at the general meeting. Second, if, following a bid, the offeror holds 75 per cent or more of the capital carrying voting rights, no restrictions on the transfer of shares or on voting rights nor any extraordinary rights of shareholders concerning the appointment or removal of board members provided for in the articles of association of the offeree company shall apply. The effect of this provision is, again, that all shareholders are to exercise one vote per share at the general meeting convened by a successful offeror in order to amend the articles of association or to remove or appoint board members.

The principle behind Art 11 is the realisation that, if restructuring of companies and capital markets are to be facilitated, entrenched company rights must give way. The principle is not novel in company law, but the Directive's approach is too radical. Company law in general has always sought to achieve a balance between the rights secured by shareholders as a reflection of their bargains, and the economical need to remove barriers that stifle the expansion of company business. Where rights are contained in the articles of association of the company, company law provides for a mechanism of altering the articles.[30] Where the rights are classified as class rights, which may include multiple-voting rights attached to particular shares, company law provides a particular mechanism for altering or removing such rights.[31] Minority shareholders who have certain rights entrenched in the articles of association, such as the right to appoint a director, are particularly protected in company law.[32] Where the rights cannot be altered or removed by other mechanisms, company law provides a compromise arrangement that involves the holders of the rights and the courts.[33] What the Directive requires in

30 For instance, CA 2006, s 21 allows shareholders to alter provisions in the articles of association by passing a special resolution, that is, 75 per cent of the majority shareholders must agree to the alteration. The alteration, however, must be for the benefit of shareholders and not merely for the company as a legal entity – *Allen v Gold Reefs of West Africa* [1900] 1 Ch 656; *Greenhalgh v Ardene Cinemas Ltd* [1950] 2 All ER 1120.

31 The procedure is laid down in CA 2006, s 630, which requires consent of at least 75 per cent of shareholders of a particular class affected.

32 In *Cumbrian Newspapers Group Ltd v Cumberland & Westmoreland Herald Newspaper & Printing Co Ltd* [1987] Ch 1 a minority shareholder holding only 10 per cent of the shares successfully claimed class rights, including the right to appoint a director.

33 CA 2006, s 895 provides a particular procedure that involves making compromises and arrangements. This broadly requires meetings of holders of the rights, and approval by the courts of the compromise reached with holders of those rights.

Art 11 is tantamount to a radical approach that cuts through and ignores the provisions of UK company law – an approach which UK participants are not accustomed to and would undoubtedly find hard to accept.

The rights attached to shares not only represent the financial interest of the shareholder in the company but also reflect investment bargains the shareholders made when they bought the shares, and, money being at stake, which require protection. Unless the purported rights are mere privileges,[34] the holders are vested with expectations that their bargains will be protected. Where rights exist, it is only fair that when such rights are to be removed, rather than simply rendering the rights ineffective, a fair mechanism is followed. Company law statutes provide a high level of protection of shareholder rights.[35] To match this protection closely, the Directive requires that shareholders who suffer any loss as a result of having their rights removed or made ineffective must be given an equitable compensation in accordance with the terms to be determined by national laws. To the extent of an equitable compensation being offered to shareholders, one would find the Directive striking the balance between on the one hand protecting the interests of shareholders, and on the other hand facilitating takeovers by removing structural barriers.

However, Art 11 is optional, such that Member States may choose not to apply it.[36] Possibly, because of the perceived complication of the compensation requirement, the UK has opted not to apply the breakthrough rule. As the UK has not opted in to Art 11 of the Directive, there is no direct rule in the Code dealing with the so-called breakthrough rule. Although the UK has opted out of this provision, nevertheless, in implementing the Directive, the CA 2006 includes a right for any company to opt into the breakthrough provision of Art 11 pursuant to Art 12 of the Directive.[37] Whether the UK

34 For example, in a recent dispute adjudicated by the Takeover Appeal Board, the Eurotunnel plc 2007/2, the appellants, had relied heavily on the decision in *Cumbrian Newspaper Group Limited v Cumberland & West Moreland Herald Newspaper & Printing Co Ltd* [1987] Ch 1, claiming that their travel privileges were class rights entitling them to either receive a separate offer or their consent to be sought before those rights could be varied. The Takeover Appeal Board, chaired by Lord Steyn, found that there was no evidence that Eurotunnel intended to create a separate class of share through its travel privileges scheme, either through the prospectus or otherwise, and that no rights attaching to the shares had been incorporated in the articles of association of the company which, if the intention was to create a separate class of shares, would normally be the case.

35 A range of provisions is available to resolve issues affecting shares – the provisions include CA 2006, ss 21, 630 and 895, discussed above.

36 Art 12 of the Directive makes Art 11 (and Art 9) optional.

37 It is clear from the CA 2006 that Art 11 of the Directive is not to be applied in all cases of takeovers. In keeping with Art 12 of the Directive, ss 966–972 of the CA 2006 provide an option for listed companies to opt in to Art 11 should they wish to. These sections provide for conditions that have to be met if listed companies wish to opt in to Art 11 – broadly, a special resolution is required for both initial opting in and subsequent opting out.

will lose out for opting out of Art 11, or whether companies will gain anything for opting in, is questionable. In the UK, the dictates of the market for securities on a regulated market have reduced the number of companies with preferential share and voting structures that would be subject to a breakthrough rule – as a result, whether or not a company should opt in to Art 11 of the Directive is unlikely to be relevant in most cases.

At any rate, a UK company opting to opt in to Art 11 of the Directive is likely to face upheaval on the question of compensation.[38] Possibly because Art 11 of the Directive is optional, and the UK has generally opted out, the issue of compensation is inadequately provided for in the CA 2006. It is not stated in the CA 2006 who is to pay, how much is to be paid, and how the courts are to determine or calculate the amount to be paid.[39] In contrast, the Code levies the compensation and its determination on the offeror.[40] The CA 2006 seems to suggest that compensation is determined by the courts, yet the Code seems to suggest that this is a matter for the offeror. Whichever interpretation is adopted, the effect of an offeror paying for compensation is to defeat incentives for investors, as it would increase the costs of takeovers and make takeovers unattractive. Moreover, a UK company that opts in has no reciprocity safety-net if faced by an offeror who does not apply Art 11 of the Directive – the alternative is to opt out again altogether. Why then would a UK company, well advised, be interested in opting in to Art 11 of the Directive in the first place?

3.4 Equal treatment of shareholders

Although the Directive adds nothing in the matter of shareholders' protection to what is already contained in the Code, even prior to the current version of the Code, the general statutory protection of shareholders is a progressive landmark in the UK. The Directive's addition is in the form of giving legal force to the provisions in the Code; prior to the Directive the Code had no legal force albeit that it was fully complied with. At the heart of the objective of protecting shareholders is the principle of equal treatment of all shareholders. Company laws have come a long way in providing an

38 CA 2006, s 968.

39 Referring to removal of company restrictions pursuant to Art 11 of the Directive, for companies that have opted in, CA 2006, s 968(6) simply provides that, if a person suffers loss as a result of any act or omission that would (but for this section) be a breach of an agreement to which this section applies, he is entitled to compensation, of such amount as the court considers just and equitable, from any person who would (but for this section) be liable to him for committing or inducing the breach.

40 Rule 24.2(d)(xv) of the Code, 8th edn, 2005, requires the offeror to include in the offer document the compensation (if any) offered for the removal of rights pursuant to Art 11 of the Directive together with particulars of the way in which the compensation is to be paid and the method employed in determining it.

effective protection of shareholder interests, especially minority shareholders. It is in this regard that the principle of equal treatment, being cemented in company law by the Directive, represents commendable progress in the UK.

From the common law perspective, shareholders have always had very little protection. First, shareholders do not manage the business of the company; it is the directors who do so.[41] Second, the directors who manage the company are not answerable to the shareholders but to the company itself.[42] The traditional statutory power of the shareholders to manage the business of the company is to appoint and remove directors from office;[43] even then, the practical dimension of this limited power lies with the majority shareholders in the general meeting, which leaves the minority less protected. In the landmark case of *Foss v Harbottle* (1843) common law showed that minority shareholders were less protected. Two points emerged in this case. First, where there is an alleged wrong on the company, the proper claimant is the company itself and not the aggrieved shareholder. Second, if the majority approved of the act of the directors, the minority shareholder could not be heard in court.

Gradually, this common law lack of adequate protection of minority shareholders changed. The courts have acknowledged the lack of protection given to minority shareholders. Indeed, in the words of Hoffmann:

> . . . the emancipation of minority shareholders is a recent event in company law. For most of the twentieth century minority shareholders were virtually defenceless, kept in cowed submission by a fire-breathing and possibly multiple-headed dragon called *Foss v Harbottle*. Only in exceptional cases could they claim protection of the court. . . . A statutory remedy was provided for the first time in 1948 but this proved relatively ineffectual. It was not until 1980 that Parliament forged the sword . . . section 459 of the CA 1985 and which enables the unfairly treated minority shareholder to slay the dragon.[44]

41 Table A Regulations Art 70 (1985) provides: 'Subject to the provisions of the Act, the memorandum and the articles and to any directions given by special resolution, the business of the company shall be managed by the directors who may exercise all the powers of the company. No alteration of the memorandum or articles and no such direction shall invalidate any prior act of the directors which would have been valid if that alteration had not been made or that direction had not been given. The powers given by this regulation shall not be limited by any special power given to the directors by the articles and a meeting of directors at which a quorum is present may exercise all powers exercisable by the directors.'

42 Directors do not, in general, owe any contractual or fiduciary duty to shareholders; see *Percival v Wright* [1902] 2 Ch 421.

43 Shareholders can remove directors from office (see CA 2006, s 168) – a company may by ordinary resolution remove a director before the expiration of his period of office, notwithstanding anything in its articles or in any agreement between it and him.

44 R Hollington, *Minority Shareholder's Rights* (Sweet & Maxwell, London 1999) Foreword [a 'Foreword' by Lord Hoffmann].

Whereas the CA 1985 offered some protection to minority shareholders, by virtue of s 459, now s 994 of the CA 2006, this has not been without its shortfalls. The principles of common law have time and again led the interpretation of s 994 to the extent that the majority of minority shareholders are looked upon to decide the fate of a minority within a minority.[45] It is perhaps due to the weakness of the common law that shareholder protection became the iconic theme of the self-regulated takeover industry, with the emergence of the Code in 1968. The Code introduced rules, including the mandatory bid rule, requiring that an acquirer who accumulated 30 per cent or more of the target company's shares to tender for all the shares at the same price has paid for the shares already acquired. The underlying objective is to prevent the transfer of effective control through selective acquisitions at inflated prices without offering the same terms to all shareholders.[46] The Directive introduces nothing novel but reaffirms the rules in the Code, and the principle of equality of treatment of all shareholders in regard to the process of a takeover.

The rules on equal treatment of shareholders are in keeping with the guiding principle developed by the Company Law Review Steering Group. The guiding principle is that company law should be primarily enabling or facilitative – which does not eliminate legal intervention – examples of which include the avoidance of substantial market failure, by providing mandatory provisions to protect shareholders.[47] Section 943 of the CA 2006 enables the Panel to make rules required to implement the Directive, which includes rules on equal treatment of shareholders. These rules are now contained in the Code.

As already stated, the main body of law implementing the Directive is contained in the Code. Under the Code, the principle of equal treatment for all shareholders has two limbs: equivalent offer value extended to all shareholders; and same information to be given to all shareholders. The rules on equivalent offer value are detailed and extensive enough to offer equal treatment to all shareholders.[48] As to providing the same information to all shareholders, the rules are equally comprehensive in order to accord equal

45 In *Smith v Croft (No 2)* [1987] 3 All ER 909, 942 (Knox J), the idea of paying regard to the views of an independent majority of shareholders within minority shareholders who petition the courts in a derivative action was developed.

46 T Tridimas, 'Self-regulation and investor protection in the UK: the takeover panel and the market for corporate control' (1991) 10 CJQ 24, 32.

47 DTI, 'Modern Company Law for a Competitive Economy – Final Report' (DTI, London July 2001) 5.

48 The rules in the Code range from requiring comparable offers (r 14); appropriate offer (r 15); no special deals (r 16); same price (r 6.1); revised offer (r 6.2); all entitled to revised offer (r 32.3); if acquired by cash then extend cash offer to all (r 11.1); to requiring that if shares are acquired by exchange of shares then the bidder must extend exchange of share offer to all shareholders (r 11.2).

treatment.[49] The rationales of the Code are the equality of access to the market as between institutional investors and their private counterparts, the protection of the minority, and the prevention of the pressure to tender.[50] To the extent of its comprehensiveness in regard to the rules, and in terms of achieving equal treatment of shareholders, the Code surpasses most regulatory rules elsewhere, including regulations in the USA,[51] – and to that extent the Code imports nothing from the Directive.

3.5 The mandatory bid principle

3.5.1 The nature and effect of the rule

Article 5 of the Directive requires Member States to have a mandatory bid rule, the object of which is the protection of minority shareholders. This requires that where a natural or legal person, as a result of his own acquisition or the acquisition by persons acting in concert with him, holds securities of a company which, added to any existing holdings of those securities of his and the holdings of those securities of persons acting in concert with him, directly or indirectly give him a specified percentage of voting rights in that company, giving him control of that company, Member States shall ensure that such a person is required to make a bid as a means of protecting the minority shareholders of that company. In the UK, this is implemented by s 943 of the CA 2006, which essentially gives effect to the relevant rules of the Code. On reaching 30 per cent of voting shares, a mandatory rule is triggered under the Code. The Directive itself does not define the threshold at which a mandatory rule is triggered. By not providing a percentage of voting rights above which control has been acquired to trigger a mandatory bid requirement, the Directive defeats its harmonising objective.

R 9 of the Code provides for a mandatory rule. This requires that:

a any person who acquires, whether by a series of transactions over a period of time or not, an interest in shares which (taken together with shares in which persons acting in concert with him are interested) carry 30 per cent or more of the voting rights of a company; or

b any person, together with persons acting in concert with him, is interested in shares which in the aggregate carry not less than 30 per cent of the voting rights of a company but does not hold shares carrying more than 50 per cent of such voting rights and such person, or any person acting in concert with him, acquires an interest in any other shares which increases the percentage of shares carrying voting rights in which he is interested;

such person shall extend offers to the holders of any class of equity share capital, whether voting or non-voting, and also to the holders of any other class of transferable securities carrying voting rights. Offers for different classes of equity share capital must be comparable; the Panel should be consulted in advance in such cases. An offer will not be required under this rule where control of the offeree company is acquired as a result of a voluntary offer made in accordance with the Code to all the holders of voting equity share capital and other transferable securities carrying voting rights.

The mandatory bid rule aims at: (1) preventing clusters of share purchases that would transfer control in the target company thereby locking in shareholders without them being offered an opportunity to decide on such control; and (2) preventing the offering of different levels of share prices without extending the same price to all shareholders. Article 5 of the Directive requires an equitable price to be extended to all remaining shareholders, which is determined by reference to the highest price paid in the previous 12 months. In suggesting an equitable price criterion, the Winter Report sought to avoid a litigation culture where issues on price would be determined by the courts. In particular, the Winter Report was of the view that it is not desirable that such a question – which will arise in the midst of a complex transaction where time is of the essence and where the issue will depend very much on particular circumstances if it is left undefined – should be determined by long-drawn-out court proceedings.[52] Thus, if the criterion is so set, national regulators will be able to determine the equitable price to be paid and participants will not need to refer the case to the European Court of Justice to determine an equitable price under the Directive.

Further, in recommending this criterion, the Winter Report sought to enable efficient functioning of capital markets in the EU by providing a sufficient degree of predictability as to the consideration to be offered in a mandatory bid.[53] By means of this criterion, an offeror is able to predict how much he will pay for the shares, and the shareholders are able to predict how much to expect. Thus, on one hand the rule prevents arbitrary control in the company against interests of other investors, and on the other hand it prevents unfair treatment of shareholders. If arbitrary control is not prevented, such control would make the holding of shares in the company unattractive

49 The rules in the Code range from requiring sufficient information dissemination by the boards – r 23; timely information – r 20.1; detailed financial information – rs 24 and 25; accurate information – r 19.1; up-to-date information – r 27.1; board to take responsibility for information – r 19.2; to requiring of the giving of same information to competing offerors – r 20.2.

50 Panel answers to DTI inquiry of July 1974, cited in MA Weinberg and MV Blank on *Takeovers and Mergers* (4th edn, Sweet & Maxwell, London 1979) 569.

51 See D DeMott, 'Current issues in tender offer regulation: lessons from the British' (1983) 58 NYUL Rev 945, 983–987.

52 Winter Report (2002) 48.

53 Winter Report (2002) 49.

for the other shareholders who are denied an opportunity to assess whether to remain holding shares in the company or to sell off their shares.

However, the very rule is capable of escalating arbitrary control, as uncertainty increases when shareholders are lured by the offer and many shareholders give in, rendering the others minority shareholders and making shareholding for such a minority less attractive. An investor who may only want to raise his portfolio to, say, 35 per cent, leaving other shareholders in investment, is forced by the rule to bid for all remaining shares, causing a panic of sale by other shareholders who otherwise would have lived with a 35 per cent majority shareholder. It is, however, difficult to see a better way than by a mandatory rule regulation. If it is left to the market forces of demand and supply, minority shareholders may not even have the remedy of selling their shares at a fair price. But a point not to be ignored is the effect of acceleration of arbitrary control in the company causing a squeeze-out of the minority, who may not have the means to invest elsewhere, thereby destabilising minority investment portfolios.

The mandatory rule also has the potential of limiting investment growth to 29.9 per cent, as beyond that point an investor must make a mandatory bid to buy all the shares. Thus, small-stake investors cannot invest beyond 29.9 per cent unless they have enough capital to own all the shares in a company. Other than a condition of obtaining 50 per cent or more acceptances, Rule 13 of the Code limits an investor's ability to attach conditions to the offer. Thus, if an investor cannot comply with all the requirements, his only option lies in maintaining a low share portfolio capped at 29.9 per cent and to sell his shares to a majority and wealthier bidder.

Whether a mandatory rule is justified in legal terms is another matter. Enriques argues that, whilst well-identified interest groups will gain from an EC mandatory bid rule provision, the rule has no legal justification in terms of equal treatment. Enriques argues:

> . . . some it cannot be viewed as an application of the general principle that companies have a duty of equal treatment of shareholders, because in our setting the 'relationship between the shareholders horizontally' is involved, and European company laws have no principle imposing equal treatment horizontally.[54]

This is arguably an example of how takeover rules have the effect of altering the understanding of mainstream company laws. The alternative way of looking at this point is to view takeover rules as not imposing the equal treatment duty on companies but rather on investors or bidders (whether legal persons

54 L Enriques, 'The Mandatory Bid Rule in the Proposed EC Takeover Directive: Harmonization as Rent-Seeking?' in G Ferrarini and others (eds), *Reforming Company and Takeover Law in Europe* (OUP, Oxford 2004) 767, 790.

or natural persons). In such an alternative view, a mandatory bid has legal justification by way of equal treatment under capital markets generally beyond a narrow understanding of company laws. But even under company laws, the duty is legally justified as our company laws do not particularly address the question of duties owed by investors or bidders to shareholders.

3.5.2 Progressive application of the mandatory rule

Under the so-called self-regulation, the Panel in general applied the mandatory rule, and other rules, in a flexible manner. There is a need to define in practical terms what is meant by the flexibility of the Panel. A good example is given by Tridimas,[55] where the Panel created an exception around its mandatory requirement rule. Following the October 1987 stock market crash and the failure of the British Petroleum privatisation, the Bank of England offered to repurchase British Petroleum's partly paid shares from private investors. This had the effect of putting the shareholding of the Bank of England to 36 per cent, which in accordance with the Code would have required the Bank of England to make a mandatory offer to all investors. Because of the flexibility of the Panel, the Panel agreed that, if the Bank of England were to purchase the shares and thereby reach a 36 per cent stake, it would not be required to make a mandatory offer, provided the Bank of England agreed to vote only 29.9 per cent of its shareholding. It is this kind of flexibility that was lost when the Panel was transformed from self-regulator to statutory regulator. However, this so-called flexibility is capable of rendering takeover rules uncertain. To avert this uncertainty, whilst the Panel may change the rules in the Code, s 944 of the CA 2006 now requires that the Panel publishes such changes first. As such, the flexibility that would allow the Panel to suddenly change the rules, thereby causing uncertainty, has been limited.

Like any other rule, there are often parties who would seek to evade the rules through some loophole. The mandatory rule requires that the same price paid for the shares within the last 12 months be offered for all the remaining shares. The offeror includes all concerted parties – these being parties that collude to buy shares or that may later hold shares in common. In *Gilgate Holdings Ltd*,[56] a number of parties bought shares in a manner that was against the spirit of the rule, and yet they were not found to be in breach of the rule. These parties bought 29 per cent of the shares at 22.5 pence per share, and after 12 months plus one day they bought more shares equivalent to 7 per cent at only 8.75 pence per share. This meant that enforcing the mandatory bid required the concerted parties to offer to pay only 8.75 pence per share, being the highest price they had paid for shares in the previous

55 T Tridimas, 'Self-regulation and investor protection in the UK: the takeover panel and the market for corporate control' (1991) 10 CJQ 24, 30.

56 <http://www.thetakeoverpanel.org.uk/new/statements/DATA/1980/1980-01.pdf> Panel Statement (14 March 1980) accessed 20 July 2006.

12 months. This loophole is not covered by the Code in its present form and is not covered by the Directive as implemented by the CA 2006.

Another way that parties may seek to avoid triggering a mandatory rule is to use other parties to acquire shares. The terminology used to refer to such other parties is parties acting in concert. A definition of parties acting in concert is given in the Code. The definition is wide enough to cover general behaviours parties may develop to avoid the scourge of a mandatory rule. Parties acting in concert comprise persons who, pursuant to an agreement or understanding (whether formal or informal), cooperate to obtain or consolidate control of a company or to frustrate the successful outcome of an offer for a company. Under the Code, the definition of persons acting in concert presumes certain persons to be acting in concert,[57] the effect of which is to close this loophole, making the mandatory rule effective.

3.5.3 Economic reasoning on equal treatment

There is an argument that it is wasteful to regulate takeover activities if only to achieve equal treatment of shareholders by way of a mandatory rule. Easterbrook and Feschel argue that shareholders need not be treated equally in a particular takeover transaction, because, by diversifying their investment portfolios, investors may protect against the risk of consistently falling on the losing side of unequal treatment.[58] The authors argue that if the market can even out apparent inequality in this way, the costs of unneeded regulation to promote equality might well be thought socially wasteful.[59]

However, DeMott,[60] in response to this market argument, finds that the total portfolios of most individual investors are so small that they are

57 Under 'Definitions' of the Code, persons presumed to be persons acting in concert with other persons include: (1) A company, its parent, subsidiaries and fellow subsidiaries, and their associated companies, and companies of which such companies are associated companies, all with each other (for this purpose ownership or control of 20 per cent or more of the equity share capital of a company is regarded as the test of associated company status); (2) A company with any of its directors (together with their close relatives and related trusts); (3) A company with any of its pension funds and the pension funds of any company covered in (1); (4) A fund manager (including an exempt fund manager) with any investment company, unit trust or other person whose investments such fund manager manages on a discretionary basis, in respect of the relevant investment accounts; (5) A connected adviser with its client and, if its client is acting in concert with an offeror or with the offeree company, with that offeror or with that offeree company respectively, in each case in respect of the interests in shares of that adviser and persons controlling, controlled by or under the same control as that adviser (except in the capacity of an exempt fund manager or an exempt principal trader); and (6) Directors of a company which is subject to an offer or where the directors have reason to believe a bona fide offer for their company may be imminent.

58 F Easterbrook and D Feschel, 'Corporate control transactions' (1982) 91 Yale LJ 698, 712–14.

59 F Easterbrook and D Feschel, 'Corporate control transactions' (1982) 91 Yale LJ 698, 708–11.

60 D DeMott, 'Current issues in tender offer regulation: lessons from the British' (1983) 58 NYUL Rev 945, 983.

unlikely to achieve adequate diversification through direct investment in shares, and that adequate diversification is difficult to achieve in the light of the difficulty of determining in advance what investments might be subject to some degree of unequal treatment in an acquisition transaction. Thus, a legal response by way of the Directive that affirms the long-standing principle of the Code should be seen as the most appropriate protection of shareholders' interests.

3.6 Squeeze-out and sell-out

The notion of a squeeze-out refers to the right of a majority shareholder to buy out a minority shareholder, and the notion of a sell-out refers to the right of a minority shareholder to sell to a majority shareholder. Anticipating an increased post-takeover share value, shareholders may hold out during the bid, and hope to sell at a later stage, creating the free-rider problem. The squeeze-out allows the bidder to overcome the free-rider problem.[61] These rights are contained in Arts 15 and 16 of the Directive, which were a result of the recommendations of the Winter Report. Article 15 deals with the squeeze-out right and Art 16 deals with the sell-out right. These rights have long existed under UK company laws; specifically, they were provided for under Pt 13A of the CA 1985. The implementation of Arts 15 and 16 under the CA 2006 simply restates with minor changes the provisions under Pt 13A.[62] However, the acceptance of the squeeze-out right in company law is in effect a promotion of capitalism at the cost of protection of minority shareholders where such minority does not wish to give up its shareholding. It is a naïve law's response to commercial demands and reality.

Articles 15 and 16 of the Directive were adopted from the recommendations of the Winter Report.[63] The Winter Report found that both the squeeze-out right and the sell-out right, prior to the Directive, were not regulated at European Union level. The Winter Report also found that these rights existed in most Member States but were applied with greater diversity. There was therefore a need to regulate and harmonise these rights at European Union level. In the light of the greater diversity of squeeze-out and sell-out regimes in different Member States, the Winter Report recommended that Member States should have the possibility of setting the threshold for triggering the squeeze-out right either by reference to the capital (between 90 per cent and 95 per cent) or by reference to the number of acceptances of the offer (at 90 per cent). A threshold for a sell-out right was also recommended to be

61 M Burkart and F Panunzi, 'Mandatory bids, squeeze-out and the dynamics of the tender offer process' in G Ferrarini and others (eds), *Reforming Company and Takeover Law in Europe* (OUP, Oxford 2004) 737, 793.

62 Sections 974–991 of the CA 2006 restate provisions in Pt 13A of the CA 1985, incorporating recommendations of the Company Law Review 2001, and in line with the Directive.

63 The Winter Report (2002) 67–8.

determined by reference to the capital (between 90 per cent and 95 per cent). Further, where there are several classes of securities outstanding, the Winter Report recommended that the rights (squeeze-out and sell-out) should apply on a class-by-class basis. The provisions contained in Arts 15 and 16 of the Directive largely adopt the recommendations in the Winter Report.

At common law, a company that made an offer for another company's shares had no power to compel any shareholder to part with his holding against his will. This common law position changed with the enactment of the Companies Act 1928.[64] Subsequently over the years the right of squeeze-out, together with the right of sell-out, were fully cemented in company law, under Pt 13A of the CA 1985. A restatement of these rights, taking into account the recommendations of the Company Law Review,[65] and for the purpose of implementing the Directive, are now contained in ss 974 and 991 of the CA 2006.

Paradoxically, it is at the heart of the Directive to provide protection to minority shareholders, yet for the wider public interests in seeking to keep bids more attractive for potential bidders, property rights of minority shareholders are rendered obsolete. The Winter Report considered this enigma and concluded that, so long as the squeeze-out right applies only when the minority is fairly small and appropriate compensation is offered, the use of squeeze-out to address these public interests is appropriate. The Company Law Review Steering Group saw the minority's plight as follows:

> A minority shareholder, without control over the company, and most probably without any ready yardstick against which to measure the value of his shares, the strength of his bargaining position is in any event based solely on *his ability to refuse to sell*. We do not think that it would be possible to devise . . . sufficient safeguards to protect a minority shareholder's interests, to justify depriving him of the one card of value he retains in his hand.[66]

It is a pity that the Company Law Review Steering Group, as well, recognised the infringement of property rights that a compulsory squeeze-out creates, and could only empathise with the plight of minority shareholders. Although squeeze-out rights have long been accepted as part of company law in the

64 This was followed by the Companies Act 1948 of which s 209 imposed an equivalent of a squeeze-out right by which a minority shareholder was compelled to sell his shares to a successful bidder who became a majority shareholder: see also *Re Castner-Kellner Alkali Co Ltd* [1930] 2 Ch 349; and *Re Hoare & Co Ltd* [1933] All ER Rep 105.

65 See DTI, 'Modern Company Law for a Competitive Economy – Final Report' (DTI, London July 2001) 292.

66 DTI, 'Modern Company Law for a Competitive Economy – Final Report' (DTI, 2001) 283 – emphasis added.

UK, it does not seem right that a shareholder should be compelled to sell his shares, rendering shareholding an illusory right.

If the bidder who has either acquired, or contracted to acquire, 90 per cent or more of the shares carrying voting rights in a given class of shares, wishes to acquire the remaining shares in the target company, he may give notice of his intention and require the holders of the remaining shares to sell those shares to him. This notice must be given to the minority shareholder within three months of the bidder acquiring the threshold shares.[67] It would appear that the mere fact that the minority shareholder does not wish to sell his shares is no ground for defeating a compulsory purchase of his shares. The courts have, under the old statutory regimes, only looked at applications resisting compulsory purchase if founded on grounds that the offer was unfair; but even then the courts have not favoured such applications.[68] Moreover, the onus is on the minority shareholder to prove that the offer was unfair.[69] The test of fairness is not on whether it is fair for a minority's property rights and liberties of investment to be removed, but on whether the price offered to the minority shareholder in return is a commercially acceptable offer price. However, the compulsory purchase is only restricted to takeovers.[70] Thus, fairness in takeovers is all about economics, not law; and the law's intervention is only an economical dimension applied to maintain commercial usage.

Although the Winter Report found that the ability of one party to enforce the acquisition of the shares of another represents a significant infringement of the latter's vested property rights, it felt that there was a justification for such infringement. The Winter Report found that various courts in the Member States had ruled that the squeeze-out right was not to be regarded as incompatible with property rights, as the squeeze-out right is not exercised to satisfy private interests only but public interests. The Winter Report argued that without a squeeze-out right, takeover bids are less attractive to potential bidders because of the costs and risks relating to the existence of minority shareholders after the bid. The Winter Report was of the view that it is in the public interest to have companies efficiently managed on the one hand, and securities markets sufficiently liquid on the other hand. And that, so long as the squeeze-out right applies only when the minority is fairly small and

67 Art 15.4 of the Directive.

68 In *Re Bugle Press Ltd* [1961] Ch 270, 276–277 Buckley J said: 'In the ordinary case of an offer under this section [s 430C Companies Act 1985], where the 90 per cent majority who accept the offer are unconnected with the persons who are concerned with making the offer, the court pays the greatest attention to the views of that majority. In all commercial matters, where commercial people are much better able to judge of their own affairs than the court is able to do, the court is accustomed to pay the greatest attention to what commercial people who are concerned with the transaction in fact decide.'

69 *Re Gierson, Oldham and Adams Ltd* [1968] Ch 17.

70 *Re Bugle Press Ltd* [1961] Ch 270.

appropriate compensation is offered, the use of squeeze-out to address these public interests is proportionate.[71] It is difficult to see how forcing a minority shareholder out of the company against his will, thereby creating concentrated share ownership, makes takeovers attractive to potential future bidders.

Take, for example, a company that started off as a one-man private company, increased its value over the years and changed to a public company, then listed to trade its shares on a regulated market. A takeover bidder comes along and acquires 90 per cent of the shares. A minority shareholder and founder of the company wishes to retain his investment in the company for his retirement income; he pleads to the law for his vested interests. In response, the law is only concerned with whether a fair price has been offered to him. It is a naïve legal response to commercial demands and reality. If that were the law's response in protecting the vested interests of this minority shareholder, he would be horrified at the manner of protection accorded to him. In the end, the acceptance of the squeeze-out right in company law is in effect a promotion of capitalism at the expense of protecting minority shareholders who may not wish to give up their vested shareholding.

Moreover, if the shareholder being squeezed out should sacrifice his property interests for the public good to make takeovers attractive to future bidders, it is difficult to see how that rationale is justified. The bidder will in turn hold 100 per cent of the shares, turning the share structure of the company into a concentrated ownership, which makes it the more difficult for future bidders. According to Ferrell, in concentrated share ownership, especially if shares are vested in a single shareholder after a bid, 'an acquisition will only occur when – and only when – the controller consents or has somehow lost control'[72] – hence, favouring a bidder to squeeze out a minority does not attract future bidders but rather repels them. Most of continental Europe has for a long time had a concentrated share ownership structure, and so no wonder many EU Member States found the squeeze-out right favourable.

Rather than the law's naïve response to the plight of the minority shareholder who has no interest in selling his shares, a principle prohibiting prejudicial conduct of a shareholder should be developed. Under this suggested principle, the conduct of a shareholder should not prejudice the interests of the company. Lord Evershed MR said that a minority shareholder should only be squeezed out if 'the minority shareholder was in some way acting in a manner destructive or highly damaging to the interests of the company from some motives entirely of his own'.[73] In assessing a

71 See the Winter Report (2002) 61–2.

72 Allen Ferrell, 'Why Continental European takeover law matters' in G Ferrarini and others (eds), *Reforming Company and Takeover Law in Europe* (OUP, Oxford 2004) 561, 562.

73 *Re Bugle Press Ltd* [1960] 3 All ER 791, 796 (Lord Evershed MR) – the *ratio* in this case was a determination of improper use of a squeeze-out right and not how the right should be applied, which is the argument here.

shareholder's conduct, the test should be subjective and regard should only be had to the personal conduct of the shareholder in question. Nothing in the Directive precludes developing a measure applying the squeeze-out right in the manner suggested. The courts of equity would be accustomed with this body of principles. The suggested principle appears unlikely to be adopted in the present climate of opinion.[74]

3.7 Conclusion

A major task in the Directive is to strike a balance between on the one hand the objective of protecting the interests of minority shareholders, and on the other hand the objective of facilitating cross-border takeover activities. Both Arts 9 and 11 of the Directive were meant to serve these dual conflicting objectives of takeover regulation. National and political interests seem to have led to a compromise that has optimised these provisions. As such, shareholder protection remains in conflict with the need to facilitate investment through unrestricted takeover activities. Whilst the UK has opted to apply Art 9, as it always has done, many other Member States are likely to opt out of Art 9, as they always have done. The likely result is a weak facilitation of cross-border takeover activities. However, the principles of equal treatment of shareholders and the mandatory bid rule, to an extent, promote the protection of shareholder interests.

The protection accorded to minority shareholders at common law has always been very weak. Takeover regulations, pre-dating the Directive, have sought to vest decision-making powers in the hands of shareholders in a takeover situation. Article 9 of the Directive furthers this by seeking to promote shareholder supremacy. With all the difficulties for aggrieved minority shareholders in litigating against directors, the answer lies in promoting shareholder supremacy. Regrettably, the Directive makes Art 9 optional, such that Member States are free to allow management to make the ultimate decision – even to prevent a bid. If power to decide the outcome of a takeover bid is left in the hands of directors, who are often sophisticated professionals keen to promote the interest of the company but only if that does not endanger their existence and interest, minority shareholder protection, at least in Member States that opt out of Art 9, remains a myth.

The mandatory rule contained in Art 5 of the Directive has always been a feature of the Code. Much as it is meant to prevent arbitrary control if bidders would freely buy shares, the rule is arguably capable of escalating arbitrary control. An investor who may only want to raise his portfolio to, say, 35 per cent, leaving other shareholders in investment, is forced by the rule to bid for all remaining shares, causing a panic of sale by other shareholders

74 For detailed analysis of the squeeze-out right, see: B Hannigan, 'Altering the articles to allow for compulsory transfer – dragging minority shareholders to a reluctant exit' (2007) JBL 471.

who otherwise would have lived with a 35 per cent majority shareholder. The mandatory rule has the effect of accelerating arbitrary control in the company, causing a squeeze-out of the minority, who may not have the means to invest elsewhere, thereby destabilising minority investment portfolios.

Where a minority shareholder is squeezed out, the bidder will in turn hold 100 per cent of the shares, turning the share structure of the company into a concentrated ownership, which makes it more difficult for future bidders. In concentrated share ownership, especially if shares are vested in a single shareholder after a bid, acquisition of shares depend on either the controller's consent or his loss of control. Hence, contrary to the Winter Report, favouring a bidder to squeeze out a minority does not attract future bidders but rather repels them. It is, however, difficult to see a better way than by a mandatory rule and squeeze-out regulation. If it is left to the market forces of demand and supply, minority shareholders may not have even the remedy of selling their shares at a fair price.

Notwithstanding concerns about the optional nature of Arts 9 and 11, and the harsh effect of the squeeze-out provision, the Directive, as implemented by the rules contained in the Code, offers a greater protection to shareholders than accorded by mainstream company law. Although the Directive adds nothing in the matter of shareholders' protection to what is already contained in the Code, even prior to the current version of the Code, it is through the Directive that the Code acquired legal force, and to that extent, the general statutory protection of shareholders is a progressive landmark in the UK in regard to takeovers.